THE COMMITTEE OF EUROPEAN SECURITIES REGULATORS

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

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INTRODUCTION

Background

1. In March 2007, the European Commission set out its proposals for a series of targeted enhancements to the UCITS Directive. One of these proposals was to replace the Simplified Prospectus (SP) for UCITS with Key Investor Information (KII) disclosures. The KII is intended to be a concise and focused presentation of the information that it is important for a prospective investor in a UCITS fund to have, covering largely the same general areas as the SP.

2. The SP, the concept of which was introduced by the UCITS Management Directive (2001/107/EC) in 2002, is widely seen as having failed to achieve its objectives. In particular, there is considered to be a continuing lack of transparency about UCITS, especially their costs and risks; the information given in the SP is not easily understood and used by the average retail investor; the SP is too lengthy and technical; its production is costly and time-consuming; SPs often exceed the Directive requirements; their content is not consistent in all Member States; and they do not assist comparisons between funds, particularly when cross-border sales are involved.

3. Since the Commission published its proposals for enhancements to the UCITS Directive, significant progress has been made on the legislative process and a near-final version of the recast Directive was adopted by the European Parliament on 13 January 2009. Articles 78 to 82 of that version contain the provisions on KII. In particular, Article 78(2) states:

   Key investor information shall include appropriate product information about the essential characteristics of the UCITS concerned, which is to be provided to investors so that they are reasonably able to understand the nature and the risks of the investment product that is being offered to them and, consequently, to take investment decisions on an informed basis.

4. The Level 1 provisions will be supplemented by implementing measures at Level 2, the precise scope of which is set out in Article 78(7). The implementing measures are to cover the detailed and exhaustive content of the key investor information to be provided to investors and the specific details of the form and presentation of that information. CESR's response to the Commission's request for assistance will form the basis for the aforementioned implementing measures.

CESR's work on the KID

5. Since the Commission requested CESR's assistance on developing KII disclosures in April 2007, CESR has been working intensively to prepare its response, in parallel with the finalisation of the revised UCITS Directive at Level 1. A sub-group of CESR's Expert Group on Investment Management (IMEG), which is chaired by Mr Lamberto Cardia, Chairman of the Italian securities regulator, the Commissione Nazionale per le Società e la Borsa (CONSOB), was formed to consider the detail of KII and to develop a recommendation on CESR's response. This sub-group is jointly chaired by the UK FSA and the French AMF and includes representatives of eight other Member States.

6. The first output of CESR's work was a set of advice that was submitted to the Commission in February 2008 (Ref. CESR/08-087). This followed a two-month public consultation held in late 2007, which included the organisation of an open hearing at CESR's premises in Paris. CESR received a significant amount of feedback to the consultation from external stakeholders, including retail investors' representatives. The Commission used CESR's

advice as the basis for the investor testing exercise it has been carrying out since March 2008, the second (and final) phase of which is due for completion by end-May 2009. CESR has also been closely involved in both the design and roll-out of the testing process.

7. Some of the key recommendations set out in CESR's advice in February 2008 included:

- The document containing the KII should be referred to as the Key Information Document or 'KID'.
- The length of the KID should be limited to two sides of A4 for all UCITS.
- The description of the strategy and objectives of the fund should be combined in a single section of the document and written in plain language.
- Two options for risk and reward disclosure should be tested: i) an improved version of the purely narrative approach and ii) a synthetic risk and reward indicator (SRRI) accompanied by a narrative explanation.
- Past performance information should be presented in a bar chart, using percentages and covering a period of up to 10 years.
- Performance scenarios should take the place of past performance data for funds which have no past performance and for which a proxy cannot be used (typically structured funds); testing should give feedback on which approaches to develop further.
- On charges, testing should assess the merits of disclosure using percentages versus cash figures.

Technical work

8. In the February 2008 advice, CESR identified a number of technical issues arising from its work that merited further consideration.[1] The issues identified fell under three of the broad disclosure headings which make up the KID: i) risk and reward; ii) past performance and iii) charges[2]. The work was to cover a wide spectrum of issues, ranging from development of a harmonised calculation methodology for an SRRI to treatment of past performance information for years in which the fund did not exist.

9. CESR established three separate working groups to analyse these issues in more detail. A selection of external stakeholders agreed to join the groups in order to provide additional expertise and a broader perspective. As with the work on the advice delivered in February 2008, the drafting groups prepared a set of recommendations for CESR's Expert Group on Investment Management.

10. This consultation paper sets out CESR's proposed approach on the technical issues. Early results from the Commission's testing have informed CESR's views on some aspects; where this is the case, this is explained in the relevant section of the paper.

11. As noted in the 'Next steps' section below, CESR plans to consult on the full package of its advice on the KID in summer 2009. That consultation will take into account, inter alia:

[1] For further details, see Annex 5, page 89 of document Ref. CESR/08-087.
[2] It follows that this paper does not cover issues related to the strategy and objectives or additional information sections of the KID.

- the work done to prepare the initial advice to the Commission submitted in February 2008;
- the final results of the Commission's testing exercise, which are due by the end of May;
- the final text of the revised UCITS Directive and the Commission's mandate to CESR in relation to Level 2 measures; and
- the outcome of this consultation.

12. Although there will be a further round of consultation on the advice, CESR felt it appropriate to cover the aforementioned technical issues in a separate document now, in order to allow stakeholders sufficient opportunity to give their feedback.

13. This consultation paper identifies the options available for the KID in the areas of risk and reward, past performance or performance scenarios, and charges. It provides a detailed description of the different policy options and describes their potential positive and negative effects. This is consistent with steps 3 and 4 of the 3L3 Impact Assessment Guidelines.[3]

14. The consultation does not discuss issues relating to the costs of CESR's proposals or ask specific questions about them. This is because the Commission intends to undertake an exercise in the course of 2009 to gather information on the likely costs of implementing the KID proposals. A full assessment of the costs and benefits of the policy options and a policy proposal will be included in the consultation on the final advice to the Commission later in the year (this corresponds to steps 5 and 6 of the Impact Assessment Guidelines). However, respondents to this consultation are welcome to comment on this matter, and CESR will take any such representations into account when preparing its final advice to the Commission.

Areas covered by this Paper

Risk and reward

15. The consultation recalls the two options for risk and reward disclosure identified in the February 2008 advice – an improved version of the narrative approach versus a synthetic risk and reward indicator – while focusing on the development of a harmonised calculation methodology for the latter. It is important to note the valuable input provided by the industry experts that participated in the CESR work in this area. The proposal developed by the drafting group with the assistance of these experts is presented in Chapter 1.

16. This consultation is not primarily seeking views on the respective merits of an enhanced narrative approach or a synthetic indicator as such. Rather, CESR is seeking feedback on the different elements that might make up the methodology for the indicator. Key points for discussion include the use of volatility as the basis for the calculation; the length of the time series for the data used; and whether the methodology should be developed in such a way as to promote stability of the categorisation.

Past performance or performance scenarios, where relevant

17. As reflected in the structure of the paper, the discussion on past performance can be sub-divided into two categories: i) disclosures for funds that have actual past performance data and ii) disclosures for structured funds, for which by definition no meaningful past performance information can be displayed. For the first category, CESR makes a number of proposals designed to underpin the recommendations in the February 2008 advice. These

[3] http://www.cesr.eu/index.php?docid=5043

relate to the calculation of the past performance data, treatment of situations in which there has been a material change (such as a new investment strategy or a change of manager), the handling of benchmarks and the circumstances in which a track record extension may be used.

18. The final text of the revised UCITS Directive refers to 'performance scenarios' taking the place of past performance information in the KID, where appropriate. This is the case for structured funds (also known as formula funds). The February 2008 advice recommended three approaches for the testing exercise: scenarios, back-testing and probability tables. The consultation sets out CESR's view that, in light of the results of the first phase of the testing exercise, back-testing poses too many risks of misinterpretation and should not be pursued. There is further consideration of the remaining two options and the pros and cons of each, on which feedback from respondents would be welcome. In general, three criteria need to be weighed against one another: the reliability/accuracy of the information displayed; the ability of investors to understand and interpret the disclosures; and the potential challenges faced by supervisory authorities in monitoring their application.

Charges

19. CESR's proposals on charges cover several points related to the overall presentation of the disclosures, in particular the so-called 'illustration of charges' approach which uses cash figures instead of percentages. CESR then sets out detailed proposals on harmonising calculation of the ongoing charges disclosure; this would replace the Total Expense Ratio currently referred to in the Commission's Recommendation.[4] Other issues covered include performance fees, portfolio transaction costs and the handling of charges information for new funds (or where there has been a material change in the charging structure).

Next steps

20. This consultation will close on 15 May 2009. In light of responses received and the final results of the Commission's testing exercise, CESR will formulate its proposals on the full package of advice on KID disclosures. CESR plans to publish a consultation on those proposals in summer 2009. An open hearing will also be organised to discuss the recommendations. Following the consultation process, CESR will take final decisions before submitting its advice to the Commission by the end of October 2009.

21. All contributions to the consultation can be submitted online via CESR's website (www.cesr.eu) under the heading 'Consultations' by 15 May 2009.

[4] Commission Recommendation 2004/384/EC of 27 April 2004 on some contents of the simplified prospectus

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CHAPTER 1

Risk and reward disclosure

1. In many simplified prospectuses, a list of all possible investment risks is provided to comply with the current Directive requirements and the Commission Recommendation. This is not useful to investors and is provided for legal reasons only, presenting one of the major shortcomings of the simplified prospectus.

2. The Level 1 measures (Article 78 (3)) of the draft recast of the Directive will require that:

> *'Key investor information shall provide information on the following essential elements in respect of the UCITS concerned: [...]*
>
> *e) risk and reward profile of the investment, including appropriate guidance on and warnings of the risks associated with investments in the relevant UCITS [...]'.*

3. The request for assistance from the Commission explicitly asks CESR to deliver advice on possible ways to improve risk and reward disclosure by ensuring that only relevant risks are mentioned and explained, and to consider whether a synthetic indicator could be required.

4. CESR, in its advice to the Commission, suggested that possible options include:

- Option A: trying to enhance the current purely narrative approach;
- Option B: requiring a synthetic indicator, but with an accompanying explanatory text.

In this consultation, CESR is seeking views on the technical issues that would need to be addressed for Option B. The merits and limits of a synthetic risk and reward indicator versus a purely narrative approach will be addressed at a later stage, in the further consultation on the full package of advice on the KID this summer.

1.1 Option A – enhanced narrative approach

5. In the first phase of the Commission's consumer testing exercise, assessment of risk variants was divided between one that presented risk in a narrative format and one with a synthetic indicator. Overall, there were not many differences in investors' understanding of the description of risk and reward between the narrative approach and the synthetic indicator approach. However, there was a significant leaning among investors for a visual or graphical way of representing the relationship between risks and rewards (i.e. towards a synthetic indicator). The Commission is continuing to test the use of an enhanced narrative approach in its current phase of testing and it is hoped the results of this testing will provide valuable information as to which approach consumers prefer, understand and find most valuable.

6. The working group tasked with examining the disclosure of risk and reward within the KID has to date focused on issues relating to the synthetic risk and reward indicator. CESR will develop further proposals for its final advice if the results of the second phase of consumer testing support continued consideration of the pure narrative disclosure option.

1.2 Option B - synthetic risk and reward indicator

1.2.1 Grid of fundamental requirements set out by CESR

7. As part of its work in Phase 1, CESR set out a grid of criteria that any calculation methodology and presentation of a synthetic risk and reward indicator should comply with. Based on this grid, the requirements are the following:

- Applicability to as many funds as possible
- Robust calculation methodology with no room for manipulation
- Easy implementation by UCITS providers
- Easy and effective supervision by the regulators
- Stability and robustness of the categorisation against normal changes in the risk of capital markets
- Clarity regarding limitations, in particular regarding the potential loss in the lowest classes and regarding potential loss in extreme adverse market circumstances
- Clarity that categorisation does not imply any guarantee
- As simple as possible to be user-friendly to and understandable by average investors

1.2.2 Presentation of the option

8. In its initial advice, CESR considered that an alternative option for risk and reward disclosures was a synthetic indicator. However, CESR acknowledged a common methodology was required to assign a risk category to each UCITS fund. In addition, CESR suggested that one single numeric scale, for all funds if possible, might be appropriate as it would be simple to understand and meaningful for investors (i.e. conveying the meaning of different categories in terms of potential gains or losses). Moreover, the indicator must not be misleading. In particular, it should allow investors to understand that low risk differs from no risk at all. Limitations to the overall accuracy of the indicator should also be exposed and should not be confusing for investors.

9. Findings from Phase 1 of the Commission's testing exercise revealed that investors seem to be more confident in their ability to compare funds and assess their level of risk when they are provided with the synthetic risk indicator. It appeared also that their real level of understanding was not impacted.

10. In order to take forward the outstanding technical issues on risk and reward disclosures identified in its February 2008 advice, CESR established a specific drafting group composed of regulators and industry representatives. With a view to having an appropriate sample of industry experts, CESR requested EFAMA's assistance on identifying suitable individuals that would be willing to participate in the work. The association nominated four such experts with a broad range of industry experience; CESR then appointed these experts as members of the drafting group. The proposal for a methodology underlying a synthetic risk and reward indicator set out below represents the outcome of the drafting group's work. CESR is very grateful for the significant contribution the experts' input has had in the formulation of its proposals.

1.2.3 The proposed methodology

11. The proposed methodology can be summarised as follows. The risk and reward profile of UCITS funds may be represented by calculating, whenever possible, the average volatility of the fund based on a series of investment returns (past performance) over an historical period of 3 to 5 years (3 years for funds with weekly returns, 5 years for funds with less frequent returns). However, two specific (but not unusual) situations may arise that need to be addressed:

- UCITS that have not been in existence long enough to generate the required length of time series; and
- UCITS where the volatility of the historical return series is not expected to represent the future risk and reward profile.

12. Three possible adaptations of the methodology are proposed to address these situations:

- assigning certain types of fund automatically to the highest risk category
- applying a risk 'add-on' by moving the fund one category higher than its volatility history would require
- applying a 'modifier' to the assigned category, represented by an exclamation mark after the number, to show that it has particular risk characteristics.

A methodology that covers all UCITS types

13. In this section we outline the proposed methodology for the indicator, with the choice of the risk measure and the general estimation methodology. The fundamental idea is to use the volatility of the realised past performance of the fund as a quantitative measure. Risk categories are then assigned by defining volatility 'buckets'.

14. For funds with an insufficient history, the volatility used for categorisation will be calculated by combining (the volatility of) the available performance history and (the volatility of) a return series representative of the way the product would have behaved in the past. Very often, the benchmark or reference index of a fund can serve as a basis, but – depending on the fund type – other ways to arrive at a representative volatility will be necessary.

15. The application to different types of fund with different lengths of history is discussed in section 1.2.4. In general, the aim is to establish a rules-based approach that provides a sufficiently uniform methodology for categorising comparable fund types.

The Risk Measure: Historical Volatility

16. Investments expose investors to risk. Investment products therefore carry the legal disclaimer that returns may fluctuate and that the past should not be seen as an indication of the future.

17. In line with this disclaimer, the methodology formalises risk as the dispersion of returns, where larger return fluctuations give rise to greater dispersion and smaller fluctuations imply less dispersion. Dispersion is operationalised as return volatility, and the historical volatility (square root of variance) of the fund return is proposed as the risk measure for the risk indicator. The variance is the average of the squared return deviations from the mean, and historical variance can be estimated from returns over some historical period. Estimation details are outlined in paragraph 32 onwards of this chapter.

The choice of volatility

18. The use of historical volatility can be justified by reference to the following:

a) a well-known concept: volatility forms the cornerstone of Markowitz Portfolio Theory and is hence a well-known and well-established concept in the financial industry.

b) a simple concept: as a measure of dispersion, volatility is conceptually easy to grasp.

c) a comprehensive measure: it encompasses the risks to which the Net Asset Value (NAV) is exposed because, insofar as a fund's risk exposures cause fluctuations in its NAV, the fund's return volatility is increased (see also below).

d) a computationally simple and unambiguous measure: volatility is a simple measure that can be estimated in a very straightforward and unambiguous way from a given historical return series. Because of its computational simplicity, the historical volatility estimate is therefore:

i) easy for UCITS providers to implement;

ii) robust and hence very difficult to manipulate abusively; and

iii) easy for regulators to verify.

19. The choice of historical volatility may raise some questions. The issues underlying the choice, which go beyond the inherent advantages of volatility set out above, are discussed in more detail below.

Why historical volatility and not ex-ante volatility?

20. The methodology proposes an ex-post measure of volatility, namely volatility measured over a certain historical period. This measure reflects past return dispersion and so is a descriptive, not a predictive, metric. It is important to avoid claiming any predictability of ex-ante risk which would imply using past volatility as a predictive metric.

21. It is true that past volatility does a better job in predicting future volatility than past average return does in predicting future average return. It is also true that historical volatility cannot adjust rapidly to changing market conditions. However, a highly adaptive volatility estimator is not desirable because:

- the KID (and hence a fund's risk level) will not usually be revised more than once a year; and
- a fund could be classified as low risk when volatility levels are historically low and likely to increase over the (next) market cycle.

22. To accommodate (and in a way average out) the effect of market cycles on volatility, the methodology proposes to estimate volatilities over longer time periods (this is covered in more detail in paragraphs 32 onwards).

23. When considering ex-ante volatility, the question arises how to estimate prospective volatility. Ex-ante volatility is a highly subjective concept and putting it into practice would:

- require significant additional assumptions to be made, for example on the stochastic process that drives time-varying volatility;
- increase the computational complexity; and
- increase the cost of implementation for UCITS providers.

24. Moreover, volatility models are developed, tested and implemented for short (trading) horizons, not for annual periods. Their validity cannot readily be generalised for longer time horizons.

25. For these reasons, ex-ante volatility is not proposed as the basis for the methodology. In contrast, by prescribing precise rules for estimating historical volatility, a more objective approach can be brought to this measure.

Is volatility a complete risk measure - what about risks other than market risk?

26. At first sight, the risk measure may not appear suitable to capture all the risks to which a fund is exposed. However, if a sufficiently long time horizon is considered, then it is likely that the other risks to which a fund or its portfolio constituents is exposed (such as liquidity risk, counterparty risk and currency risk) have materialised and affected the NAV. The impact on NAV in turn translates into fluctuations in returns and hence in historical return volatility.

Is volatility a complete risk measure - what about event risk?

27. Forces acting upon the fund's NAV contribute to the volatility of its return. To some extent this also applies to event risk, as extreme events that occurred during the estimation period more than proportionally contribute to the level of volatility. However, since extreme events are by definition of a low frequency / high impact nature, relevant exposures of the fund to event risk warrant specific additional mention in the text accompanying the risk indicator (see section 1.2.10) and may require to be adequately addressed.

Is volatility a complete risk measure - what about non-normal return distributions?

28. Markowitz formalised the subjective notion of investment risk and operationalised the concept by means of the standard deviation. Markowitz' preferred choice was the semi-variance (or semi-standard deviation), taking into account only the (squared) deviations below the mean return. However, when return distributions are (approximately) symmetric, there is no meaningful difference between upside and downside dispersion, or between upside and downside volatility (semi-volatility).

29. It should be noted that return distributions may be skewed (a) over short observation intervals, e.g. daily and (b) for 'sophisticated' UCITS funds that apply derivatives or dynamic trading strategies (including market timing strategies). However, when increasing the observation interval to weekly and, notably, monthly periods, the distributions of returns on market funds tend to become symmetric – especially when considering large diversified portfolios.

30. For funds where the underlying investment strategy implies distributional asymmetries, the proposed methodology foresees the use of a volatility estimate reflecting the downside dispersion, including use of a risk 'add-on'. Such an 'add-on' may also be used in the case where insufficient fund history is available and the return history is extended with returns on an index or representative asset mix. This issue is discussed further in section 1.2.4.

31. In this context, it should be stressed that an explicit distribution assumption would only be needed where there was a desire to use volatility to infer the probability or frequency that a return may be lower or higher than some given value (i.e. the quantiles of that distribution).

Estimation Methodology

The formula for volatility

32. Using the standard statistical methods the volatility of a fund is taken to be:

$$\text{volatility(r[f])} = \sigma_f = \sqrt{\frac{m}{T-1}\sum_{t=1}^{T} r_{f,t} - \bar{r}_{f,t}^{\,2}}$$

where the time-weighted fund returns $r_{f,t}$ are measured over T periods of 1/m years, and where $\bar{r}_{f,t}$ is the arithmetic mean of the fund return over the T periods :

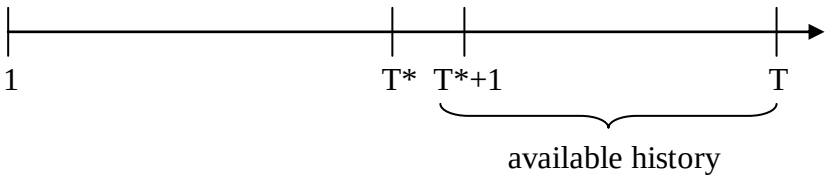
$$\bar{r}_{f,t} \equiv \frac{1}{T}\sum_{t=1}^{T} r_{f,t}$$

In this example, weekly returns are used so m=52.

Volatility estimation for new funds and funds with insufficient history

33. This issue is discussed below in the context of market funds. For strategy funds and complex / guaranteed funds, the volatility is derived from Value at Risk (VaR) or risk limits; pro-forma or representative asset mixes; or current or representative asset mixes (which are discussed later in this section).

34. For new funds that lack sufficient data history, and for funds that have revised their investment policy substantially over the most recent T months, the methodology assumes that the relevant fund return history is available from periods T*+1 to T (most recent) :



35. The methodology further assumes that a representative index, portfolio mix or benchmark is identified for which returns over the period [1,T*] are available. The volatility of the fund should then be calculated according to the following procedure.

- take the T* returns of the identified representative index, portfolio mix or benchmark over the preceding periods 1 to T*

- take the T-T* available returns on the fund over the periods T*+1 to T
- chain-link (concatenate) both return series to one series over the full T periods
- estimate annualised historical volatility according to the general formula.

36. For funds where the NAV is calculated less frequently than on a weekly basis, it is proposed to calculate the annualised volatilities based on monthly data (m=12 in the above formula). The lower number of data points introduces a somewhat larger statistical uncertainty, but is clearly preferable to imposing a requirement to carry out more frequent valuations of those funds.

Length of time series and number of categories

37. The question of the length of time series and of the number of categories must be considered simultaneously, since by fixing those parameters, the stability of the categorisation is determined. Following the criteria set out in paragraph 7 above, the methodology aims to deliver a generally stable categorisation of funds. Stable would mean, for example, that a fund closely replicating the performance of a broad equity market would not have experienced a change in categories in the recent past (e.g. over the last 10 years).

38. Alternative approaches are possible, such as allowing a fund to change its category when the underlying market has gone through a longer phase of higher or lower volatility. This would indeed adequately reflect the way this fund has behaved in the past. However, it is then inevitable that the development of the risk indicator and the development of the actual current market risk would be decoupled. For example, a fund might be assigned to a lower (better) risk category immediately before some market turbulence. Even if the backward-looking characteristics of the indicator are mentioned in the disclaimer, contradictory movements of risk indicators and the actual market situation will put the acceptance of the risk indicator in jeopardy.

39. Requiring the categorisation to be stable leads to the following trade-off: when using a larger number of narrower volatility intervals, a longer time series of historical performance data is needed to ensure sufficient stability of historic volatility. On the other hand, a smaller set of broader volatility intervals can handle shorter time series.

40. The proposed methodology is based on a time series of at least 3 to 5 years of weekly data and a 7-category scale.

41. However, an issue regarding a potential crowding of funds in one category remains: historical analysis shows that among equity funds, the variation of such volatility over time is larger than the difference of volatility between different equity segments. It is highly likely, therefore, that either (a) most equity funds will end up in the same category or (b) borders between categories are set in such a way that equity funds fall into two different categories, with the result that migrations between these categories are rather frequent.

Questions for the consultation

1. Would the proposed calculation methodology lead to a categorisation of funds' potential risk and reward 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 risk etc.?

3. Could implementation of the methodology and flanking measures 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?

1.2.4 Application to different fund types

42. As laid out above, the general idea is to use the realised performance of a fund as far as possible to calculate volatility and thus determine the category. To make this idea work in practice, additional procedures need to be defined when there is no realised performance record (as for new funds) or the record is shorter than the required length of time series. There can also be cases where the historical return series is, with respect to volatility, not expected to be representative for the future returns of the fund. This may be the case for funds that are designed to change their investment policy over time, such as life cycle funds, or guaranteed funds that can change their risk profile significantly in the course of time. Such funds could either be treated like new funds (e.g. life cycle funds entering another phase of their cycle), or could adopt risk 'add-ons' or alternative ways to determine a representative risk level, that adequately reflect the possibility of an increasing level of risk.

43. This section explains how the methodology would assign a reliable measure of volatility, and therefore a risk category, to the most important fund types. This is designed to show that the proposed approach can be put into practice in a reasonable fashion for the vast majority of fund products. It must be mentioned, however, that – when faced with a data history that is too short or not sufficiently representative – the exact method of filling the gap in the history will often depend greatly on the individual features of the product. Thus the choice of methodology will often require some qualitative judgement and cannot be derived from a set of algorithmic rules. However, the UCITS operator should be able to justify its choice on the basis of the fund's investment policy, its representative asset mix, and potential changes to its risk profile. The following cases are to be viewed as examples of how certain fund types can be treated and not as proposals for mandatory decision requirements or for which approach to use under which conditions.

44. The methodology distinguishes three general types of fund:

Market funds: Funds investing into fixed segments of the capital markets in such a fashion that their overall risk arises predominantly from the risk of the underlying market segments and their development over time, and less from the active investment decisions made by the portfolio manager. These are the 'classic' investment funds with a mostly static asset mix, including in particular funds managed closely against a benchmark.

Strategy funds: Funds managed such that their overall risk profile is not predominantly driven by the risk of fixed market segments but is determined by active allocation decisions made by the manager following a specific strategy. These funds have an actively-managed dynamic asset mix and include, in particular, absolute or total return funds. They also include the so-called life cycle funds, where the asset mix – and thus the risk profile – changes significantly but quite predictably over time.

Structured funds (including guaranteed funds): Funds that contain any additional structuring of the risk resulting from investments into capital markets. This additional structuring can be, for example, a guarantee (or a floor), or a formula-specified contingent payout profile (i.e. with optionalities), or a combination of those. Many 'sophisticated' UCITS would fall into this category.

45. Broadly speaking, the underlying reasoning is that the risk profile of a fund is determined by its exposures and potential changes thereof. These exposures in turn are determined by the fund's portfolio composition. When the fund's portfolio composition is fairly stable over time and the full history of fund returns is available, then the fund's volatility can be estimated on the basis of its own time series of returns. When an underlying index, benchmark or representative asset mix can be identified (as will generally be the case for market funds, total return funds and life cycle & target maturity funds), then this index, benchmark or asset mix can be used to estimate the fund's volatility. When no index or pro-forma asset mix can be identified (for example for absolute return funds), then the volatility can be derived from historical volatility, target volatility or a volatility/risk limit.

46. The application of the methodology to the different types of fund identified above is described in the following sections.

Market Funds

47. A market fund invests into fixed segments of the capital markets and (provided there are no changes in investment policy) its portfolio holdings can largely be characterised as a 'static mix'. When allowing limited room for active management, funds can be characterised as 'static mix plus'. This implies that the manager can indicate a reference index or asset mix that is representative for the fund's stated investment policy, or a benchmark against which the fund is managed.

48. The volatility estimation methodology is:

- when full T-period return history is available and the fund's investment policy has not been revised during this period, estimate the annualised volatility according to the general formula

- for new funds that lack sufficient data history, and for funds that have revised their investment policy substantially over the most recent T periods:

  i) take the relevant available fund return history

  ii) identify the fund's representative index, portfolio mix or benchmark ('proxy')

  iii) chain-link (concatenate) both return series to one series over the full T periods

  iv) estimate annualised historical volatility according to the general formula.

Note 1: For newly launched funds or funds that have recently revised their investment policy, there is no relevant history and the volatility is based completely on the return series of their proxy.

Note 2: The above procedure can also be followed when the available fund return history is not deemed representative for the current composition of the fund's portfolio.

Note 3: When a large part of a fund's return history is derived from a proxy, a risk 'add-on' may be applied by placing the fund one risk category higher than implied by the historical volatility.

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 history 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?

Strategy Funds

These funds are managed so that their overall risk profile is largely determined by (active) allocation decisions made by the manager following a specific strategy. Since their investment policy allows these funds to change their portfolio holdings substantially over time, these funds can be characterised as 'dynamic mix'. Within this class, we distinguish between (1) absolute return funds, (2) total return funds, and (3) life cycle/target maturity funds.

Absolute return funds

49. These funds aim to generate positive returns over an implicit or explicit cash benchmark by employing active strategies, and are likely to use long / short derivative positions. Because of the cash benchmark and the long / short decisions, there is no index or asset mix representative for their portfolio holdings. From the active and dynamic nature of their allocation decisions, these funds can be characterised as 'active dynamic mix'.

50. Many of these funds will be managed in line with a risk limit (in the form of a volatility or exposure limit) or the manager will be able to specify a target volatility. Even when this ex-ante risk 'budget' has not been used by the manager in the past (or the target volatility has not been reached in the past), the manager is allowed to do so under the prevailing investment policy. This suggests taking the maximum of the realised volatility and the volatility limit as the relevant volatility estimate for this type of fund.

51. The volatility estimation methodology is:

- when full T-period return history is available, take the maximum of
  - (a) the actual historical volatility and
  - (b) the volatility risk limit or the target volatility of the fund
- for new funds that lack sufficient data history, and for funds that have revised their investment policy substantially over the most recent T periods, take (b) above

52. When the risk limit is not available in the form of a volatility limit but instead as a VaR limit or an exposure limit, the methodology for deriving volatility from these VaR or exposure limits is outlined in section 1.2.6 below.

Total return funds

53. These funds aim to maximise total return relative to a benchmark by participating in rising equity and fixed-income markets. Within their investment policy, and according to market dynamics and the manager's views, the allocation across assets and asset classes may change rapidly. A risk limit or target volatility may or may not be available. From the active and dynamic nature of their allocation decisions, these funds can also be characterised as 'active dynamic mix'.

54. The volatility estimation methodology is:

- when full T-period return history is available and limit / target volatility exists, take the maximum of

  (a) the actual historical volatility

  (b) the volatility of the pro-forma asset mix that is consistent with and representative of the fund's investment policy and

  (c) the risk limit or target volatility of the fund

- for new funds that lack sufficient data history, and for funds that have revised their investment policy substantially over the most recent T periods, take the maximum of (b) and (c) above.

Life cycle / target maturity funds

55. The fund's asset allocation changes over time and tends to become more defensive as the target date approaches. Since the target allocation within the fund changes over time, not all of its return history may be representative of the current asset allocation. Since the allocation of these funds does change (gradually) over time, but not because of active (i.e. view-based) management, they can be characterised as 'passive dynamic mix'.

56. The volatility estimation methodology is:

- when full T-period return history is available and the fund has not changed its target asset mix over this full period, take the actual historical volatility;

- for new funds that lack sufficient data history, and for funds that have revised their (target) allocation substantially over the most recent T periods:

  i) take the maximum relevant fund return history

  ii) identify the fund's current (mix of) representative index(es)

  iii) combine both return series to estimate volatility, as outlined above

Structured Funds (including guaranteed funds)

57. These funds provide investors with formula-based (contingent) payout profiles, linked to market indices or asset mixes, and often provide protection from the full impact of market volatility. Depending on the level of the underlying index or mix, the risk profile of the fund will change. Examples of these funds are capital protected funds, guaranteed products and 'floor' products. Since the asset allocation in these funds does change over time, but not predominantly because of active (i.e. view-based) management, they can be characterised as 'passive dynamic mix'.

58. The difference with life cycle / target maturity-type funds is that, depending on market dynamics, the structured fund allocation (and hence its risk profile) can change quite quickly and drastically. For this reason, no return history can be deemed representative of the fund's current allocation or suitable for the estimation of its volatility. The volatility estimation methodology, for both existing and newly introduced funds, is:

- for finite maturity products – replicating portfolio (or 'delta-representation') approach:

i) use the contingent payoff profile at maturity to infer the underlying positions in zero-coupon bonds and the reference index (or mix) providing the upside potential

ii) estimate the historical volatility of this replicating portfolio, assuming its composition is constant over time

- for infinite maturity products (involving dynamic trading strategies) – current mix approach:

  i) take the historical volatility of the current mix portfolio, assuming its composition is constant over time.

59. In each case, the narrative should contain a disclaimer that, given market dynamics, the fund's risk profile can change quickly over time. The potentially changing risk profile in the risk categorisation could be addressed by:

- use of a risk 'add-on', shifting the fund one category higher than where it should be according to the mix methodology and the current mix, thus allowing for an increasing risk profile as a result of a changing mix over time;

- modifying the rating assigned on the basis of the mix, pointing the investor to the extended disclaimer on these types of fund and indicating the possibility of a quite rapid change of the fund's risk profile – it is suggested this could be done by adding an exclamation mark (!) to the category number.

60. Section 1.2.7 of this chapter provides more details on complex/structured funds, including guaranteed funds.

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?

1.2.5 External monitoring of the categorisation of a fund

61. For all funds with a sufficiently long performance history, the ongoing validation of the risk categorisation is a straightforward exercise based only on publicly available performance data.

62. If the categorisation of recently-launched or brand-new funds is to be validated before they have collected a sufficient performance history, external validation will require an assessment of whether the available realised volatility is, under the then prevailing market conditions, consistent with the given category. This inevitably requires a somewhat qualitative assessment, whoever the monitoring party may be.

63. Even if the monitoring process were to go into more detail by validating the choice of index or volatility limit that was initially used for categorisation, a qualitative assessment would

still be needed. For market funds with linear investments that might be a simple task, but for more complex products it could be more challenging.

64. However, the premise is that the dispersion of risk factors, together with the fund's exposures to these risks, determines the fund's risk profile. It follows that a fund's risk profile and potential changes to that profile over time depend on its asset mix and potential changes in this mix. The manager should be able to provide a plausibility check on the current actual, representative or derived asset mix and the potential changes therein, consistent with the investment policy. Given this asset mix profile, the adequacy of the implementation of the methodology (i.e. estimating historical return volatility) can be validated.

1.2.6 Reverse engineering volatility from a VaR limit

65. For strategy funds, the risk classification involves comparing the historical volatility, the risk limit and/or the target risk level. For some strategy funds, the risk limit or target risk level is formulated in terms of an annual VaR limit. An approximation of the volatility that is required for classifying the corresponding strategy fund can be derived from this VaR limit, as follows:

Take as an example an annual VaR limit with a confidence level of 95%. This VaR is defined by the 5% quantile of fund returns measured from the expected return one year hence. When the return distribution would be normal, this quantile is 1.65 times the standard deviation and the VaR equals :

VaR = 1.65 * volatility – expected return
= 1.65 * volatility – (risk free rate + risk premium)

Solving for the volatility:
volatility = (VaR + risk free rate + risk premium) / 1.65
= (VaR + risk free rate) / 1.65 + risk premium / 1.65
≈ (VaR + risk free rate) / 1.65

66. This is an 'optimistic' estimate of the volatility, but the difference with the actual implied volatility is only about half of the risk premium – this latter error term will be relatively small. For VaR limits with higher confidence levels, the error term will be even smaller.

67. When the return distribution is not normal, this derived volatility represents the volatility level that is relevant to characterise the potential loss level at the prevailing confidence level. From a downside risk perspective, this volatility is the relevant volatility for classifying the fund.

68. This procedure is only approximate, but it is quite simple. The alternative would be to use the average return derived from simulations to back out the implied volatility. However, this route would add considerable complexity in that it requires the simulation methodology and parameters of the simulation set-up to be specified.

69. If necessary, the risk limit should be made available to an independent party in order to validate the disclosed risk classification.

70. It is assumed that a risk limit exists. As noted in paragraph 53, when only a target risk level is available (i.e. the target may well be exceeded in the future) the proposal is to take the maximum of :

- the realised historical volatility;

- the volatility of the pro-forma asset mix that is consistent with and representative for the fund's investment policy, subject to a plausibility check by an independent party, if needed; and

- the target volatility.

71. The UCITS operator can be offered the opportunity to apply a risk 'add-on' and classify the fund one category higher. This would be the case when the fund return distribution significantly deviates from a symmetric distribution and / or there is a much higher probability of extreme returns than may reasonably be expected from a normal distribution. This risk add-on could also apply generally, for example when the manager has a large degree of freedom regarding active positioning of the fund. This is a subjective issue.

72. For strategy funds that have exposure limits rather than target or maximum VaR / volatility limits, the maximum exposures could be assumed for the most (stand-alone) risky asset classes and the historical volatility derived for this 'maximum risk asset mix'.

73. For strategy funds that claim to have no target or maximum VaR / volatility limit, the risk level cannot be gauged. It would be conservative to place these funds in category 7, indicating the highest possible risk level, subject to potential drastic changes.

1.2.7 Complex/structured funds (including guaranteed funds)

74. As noted in paragraph 57, structured funds provide investors with formula-based contingent payout profiles, linked to (equity or debt) market indices or asset mixes. These funds generally offer upside potential with some varying degree of protection against downside risk.

75. Most of these funds have a finite maturity and are structured using derivatives in order to provide some degree of capital protection. Some funds have no maturity date and are instead based on dynamic trading strategies such as Constant Proportion Portfolio Insurance (CPPI), Variable Proportion Portfolio Insurance (VPPI), Time-Invariant Portfolio Protection (TIPP) or other variations on this theme.

76. The capital protection, also referred to as a 'floor', can be unconditional: a 'hard floor' occurs when, at maturity, a certain level (generally 100% but sometimes a lower level) of the outlay is guaranteed. A 'soft floor' provides some degree of capital protection but no strict guarantee. A soft floor can be specified in terms of a confidence level and maintained with, for example, 95% probability. This would be a VaR-type floor.

77. A floor can also be conditional: according to some contingency, the initial floor can be reduced substantially or even disappear entirely. This is known as a 'knock-out feature'. The contingency could be an event such as a decrease in the reference index of more than 10%. Beyond this loss level, the floor then no longer applies in full or at all. So, the payout profile is characterised by a discontinuity and the fund is subject to 'event risk'. Examples include certain kinds of 'bonus notes' and SCARPs (structured capital-at-risk products). As far as these funds or products qualify as UCITS, they would belong in category 7, as this category is designed to cover those products (typically structured) the risk profile of which is not suited to a volatility-based methodology. This may be because particular financial mechanisms (such as conditional guarantees) render volatility meaningless (e.g. for very skewed return distributions) or because the complexity of the algorithms employed by these funds prevents the computation of a volatility measure by impeding the identification of their replicating portfolios.

78. Guaranteed funds with a hard, unconditional floor are not risk-free: their returns will show dispersion over time and the risk indicator should reflect this return dispersion. Generally,

any guarantee only applies at the maturity date and only benefits the investor when units in the UCITS are held until that date. Should the underlying risky index or risky portfolio decrease in value after the issue date, this would imply a paper loss when the title is held and a realised loss when the investor decides to remit the title to the issuing institution. After a period of time when the underlying risky index or risky portfolio shows considerable appreciation, the distance to the guaranteed floor becomes relatively large and reflects only limited protection of accumulated value. Until the maturity date, considerable unrealised value can be lost or gained when the underlying risky index or risky portfolio moves towards or away from the guaranteed value. The risk indicator is intended to express exactly this degree of return fluctuation.

79. If guaranteed funds were not classified within the risk indicator, the investor might be led to believe that these funds are risk free. Instead, guaranteed funds could be classified according to the historical volatility of their 'replicating portfolio mix' prevailing at the valuation date. Structured funds often pursue strategies which trigger reshuffling and/or rebalancing of the composition of their portfolio, depending on market dynamics; as such, the fund allocation could change over the coming year. The potentially changing risk profile could be tackled by:

- a risk add-on, shifting the fund one category higher than where it should be according to its current mix, thus allowing for an increasing risk profile over time
- adding an exclamation mark (!) to the rating on the basis of the mix, accompanied by a suitable disclaimer in the text with the risk indicator to point the investor to this risk.

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?

80. Since the risk profile of a guaranteed fund is subject to changes over time, the return history of the fund is not representative of the current risk level of the fund. Instead, the fund's volatility can be inferred from the replicating fund mix: the asset mix that would represent the fund's current replicating portfolio. The general idea is to:

- use the contingent pay-off profile at the maturity date to infer the underlying positions in zero-coupon bonds and the reference index (or mix) providing the upside potential
- estimate the historical volatility of this replicating portfolio, assuming that its composition is constant over time.

Example of a replicating portfolio approach

81. The methodology can be illustrated with an example of a 5-year guaranteed fund.

Consider a newly issued fund that offers full capital protection over its life of 5 years from now (100% floor) and 130% participation in the XYZ index. The current 5-year risk-free interest rate is 4.7% p.a.

The pro-forma calculation steps are:

- current fund value V = 100%
- the floor value B(1) is the present value of 100 at 4.7% over 5 yrs = 79.5% of current fund value to be invested
- this leaves 20.5% for 1.3 European at-the-money call options that are needed for the upside potential, so one call option C = 15.8%
- given 100% underlying, 100% exercise price, 5-year term to maturity, 4.7% risk-free rate, the dividend yield on XYZ, and using the underlying option valuation model, the implied volatility can be backed out. This gives about 25% p.a.
- this call then has a (dividend-adjusted) delta of (say) d=0.52, which implies a long position in the XYZ index of 0.52 * 100% = 52% for one call
- 1.3 calls implies a long position in the XYZ index of 1.3 * 0.52 * 100% =67.6%, so the leverage or borrowing implied by the 1.3 call option is B(2) = 67.6% - 20.5% = 47.1%)
- the current replicating portfolio is 67.6% of index XYZ and the remainder 32.4% in a 5-year zero-coupon bond
- this can be expressed by the formulas:

  $V = B(1) + 1.3*C$

  $C = d*XYZ - B(2)$

  $\therefore\ V = 1.3*d*XYZ + [\ B(1) - 1.3*B(2)\ ]$

- thus the fund can be represented by a portfolio consisting of a long position of 68% in the index XYZ and 32% in a 5-year zero bond
- using these weightings and the historical variances and co-variances of the index XYZ and a 5-year zero bond, the volatility of this mix can be estimated
- an alternative to using variances and co-variances of the portfolio components, is portfolio aggregation : combine historical return series of the portfolio constituents in the derived proportions and estimate the historical volatility of this portfolio in one step.

82. Further issues arising from this approach are set out below:

- fees and other (upfront) costs should first be deducted from the value of the portfolio

- according to the methodology outlined above, guaranteed funds would be classified in the same risk category as bond funds or mix funds, depending on the relative share of the bond position in the total portfolio (in practice, many guaranteed funds are already classified as mix funds)

- the methodology is relatively simple, and also works for more complicated products, such as capped funds etc.

- by its nature, the derived volatility is approximate, since the replicating portfolio will be an approximation and the derived portfolio mix can and will change over time

- the derived volatility will not be very sensitive to the exact composition of the replicating portfolio. For example, a risky index / bond proportion of 62% / 38% will yield a volatility that is not very different from that of a 68% / 32% mix. Over the course of a year, however, the replicating mix can change in a more substantial way. The prevailing mix at the valuation date should be used.

- The actual return history of complex / guaranteed funds could instead be used to estimate the volatility. One drawback is that the underlying replicating mix will change more or less gradually over time and so the historical volatility will represent the volatility of the average fund composition in the past, not its current composition. In addition, newly issued guaranteed funds (or structured products in general) do not have any return history. Using the replicating portfolio idea is then fully in line with the suggestion to use the representative mix for new market funds, as for total return funds and life cycle / target maturity funds

- A more exact method would be to apply 'Monte Carlo' simulation but this involves choices of simulation design and input parameters. It is difficult, if not impossible, to formulate and propose a uniform method. Taking this into account, a simulation approach would certainly not be as exact as might be expected. In addition, the risk indicator is indeed only an 'indicator'. It does not, and cannot, pretend to be a precise measure. After all, the KID does not communicate a precise volatility level but a classification according to volatility buckets. In summary, it is not certain what would be gained by applying a simulation method instead of a replicating portfolio approach.

1.2.8 Merits and drawbacks of the methodology

83. The methodology presents several merits. It is relatively simple. It is capable of covering all UCITS types and works for the most sophisticated products. The methodology is easy for the asset management industry to implement; and easy for regulators to verify as it is difficult to manipulate abusively.

84. In addition, volatility, on which the methodology is based, presents many merits as an objective measure of a fund's risk and reward profile. The concept is well-known in the asset management and broader financial industry and is easy to grasp. It encompasses most of a fund's risk exposures since those exposures contribute to the fluctuations in a fund's NAV. It is computationally simple and unambiguous.

85. However, implementation of the methodology might lead to higher costs for UCITS providers, although tools might be made available to address this.

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?

1.2.9 Presentation

86. The final sections of this chapter address the presentation of the risk indicator, including the type of the scale (use of wording, colours, numbers etc.), how to present the scale, and what disclaimers should accompany the indicator.

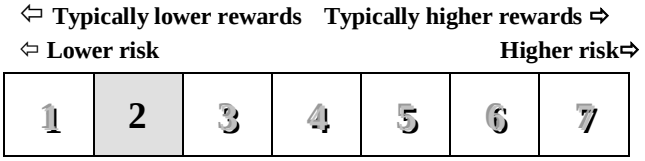
The scale

87. The scale of risk categories should be numeric and a full scale from 1 to 7 should be shown. The number of boxes is predefined by the results of the methodology. No colours are used, although a grey-scale shading may be used for the box containing the assigned category, as in the following examples.

Example of a normal return distribution fund that would fall into category 2:

Graphic or visual explanations

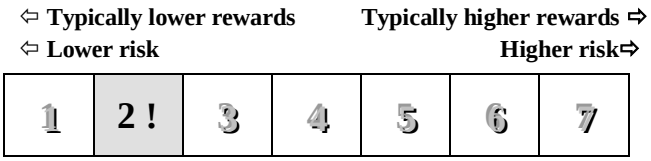
Risk and reward scale chart



Example of a non-normal return distribution fund that would fall into category 2:

Graphic or visual explanations

Risk and reward scale chart



88. If CESR decides, in the light of feedback from this consultation and the Commission's consumer testing, to proceed with a recommendation to adopt the methodology set out in this chapter, some further development and refinement of the proposal will be needed. One of the points that CESR is to address is how the results of the volatility analysis should be distributed among the 'buckets' comprising the non-linear scale i.e. how funds can be consistently assigned to a particular category. A non-linear scale would be one in which (for example) category 2 represents a volatility range from 5% to 7.5%, whereas category 3 represents the range from 7.5% to 15%, so there would not be a simple progression from one category to the next. It would not be true to say (for instance) that category 3 is twice as risky as category 2. The views of respondents on this issue would be particularly welcome.

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 than 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 more appropriate?

1.2.10 Disclaimers and explanations that should accompany a synthetic risk and reward indicator

89. CESR recommends that the synthetic indicator should be accompanied by a disclaimer to describe the limitations and shortcuts of the chosen approach.

90. Taking into account the objective of keeping the KID no longer than two pages, CESR recommends that only the following items should be addressed:

- historical data is not an indication for the future;
- the risk category of a fund is not a target or guarantee and may shift over time;
- the lowest category does not mean a risk-free investment;
- narrative explanations of classification into categories 1 and 7;
- the difference between (e.g.) class 1 and class 2 is not the same as the difference between any other two adjacent classes, and 2 does not mean twice as risky as 1;
- why the fund is in a specific category;
- where the modifier (!) is applied, narrative explanations of what it means and why it applies to the fund;
- details of the nature, timing and extent of any capital guarantee or protection; and
- a warning about whether the fund is likely to be unsuitable for investors wishing to redeem their holding within a certain period.

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?

91. On the basis of the responses to this technical consultation and the final results of the Commission's testing exercise, CESR will carry out further work in order to propose which option between the synthetic risk and reward indicator and the enhanced narrative approach should be recommended in its final advice.

CESR

CHAPTER 2

Past performance

1. The Level 1 measures (Article 78 (3)) of the draft recast of the Directive will require that:

> *'Key investor information shall provide information on the following essential elements in respect of the UCITS concerned: [...]*
>
> *c) past performance presentation or, where relevant, performance scenarios; [...]'.*

2. Thus, a distinction can be made between funds for which past performance exists or where a proxy can be deemed as representative of it, and funds for which past performance does not exist or where no proxy can be used (for example, structured and/or guaranteed funds). In its initial advice, CESR recommended that past performance information should not be shown for structured funds or 'formula funds'; and that these should be addressed through further work.

3. CESR has worked on both issues with a view to providing final advice that covers all possible situations. This work has allowed CESR to reach a consensus on options of how the 'past performance' or 'performance scenarios' could be presented in practice. This section presents recommendations on:

- specific issues that concern funds with past performance or for which a proxy can be deemed as representative of what the fund performance would have been; and
- questions surrounding the requirement of presenting 'performance scenarios' for funds without any past performance and for which no proxy can be used (typically structured or 'formula' funds, including guaranteed funds).

2.1 Funds for which past performance exists or a proxy can be used

4. Evidence suggests investors can misunderstand the limits of past performance information. However, investors typically view the information as key and are likely to seek it out. CESR questioned whether past performance information should in fact be included in the KID but on balance it considered that it should.

5. CESR examined further how the information should be prepared and shown. It took as a starting point the approach adopted by MiFID. As the MiFID requirements in this area are relatively high-level and do not require a harmonised presentation of past performance information, CESR recommended that they should be supplemented by additional requirements specific to the KID. In addition, the current UCITS Directive requires the simplified prospectus to contain information about the historical performance of the fund and a warning that this is not an indicator of future performance. A Commission Recommendation details methods for calculating and presenting past performance, including the use of net annual returns presented through a bar chart for up to ten years, and with a comparison to a benchmark where this is appropriate. Consequently, CESR proposed a presentational approach showing:

- a bar chart layout;
- percentages rather than monetary amounts;

- average yearly (net) performance rather than cumulative performance; and

- a prominent narrative text to contextualise the information and warn about its limited value as a guide to future performance.

6. Following consultation, CESR proposed the following principles in its advice to the Commission:

- the handling of charges – only figures net of charges should be shown (in general, all charges borne by the fund should be covered, preferably on a mid-to-mid or bid-to-bid basis, but the basis should be indicated where it is different to ensure consistency with any benchmark shown);

- the time periods shown – the chart should show as much data as is available up to a total of ten years;

- the yearly periods shown – to aid comparison, the same annual calendar period should be shown for all funds. However, since different funds use different accounting years, CESR does not recommend requiring audited figures to be used in all cases, but only where they are available and where they coincide with the standardised period;

- the handling of new funds – past performance should only be shown where at least one year of data is available; any years where data is not available should be clearly indicated;

- the handling of material changes to management or investment policy – there may be cases where past performance figures might be considered misleading because material changes to the investment policy or manager have occurred, so CESR recommends that any such changes and their timing should be clearly identified;

- the handling of 'simulated' data – such data should only be used in very circumscribed cases e.g. where a fund is passively managed to track an index.

7. CESR noted, however, that further technical work would be necessary on several issues relating to past performance presentation in the KID:

- the methodologies for presentation of a bar chart in view of greater standardisation;

- the calculation of past performance;

- the impact and treatment of material changes to the fund;

- the conditions under which a benchmark:

  a) can be included alongside the fund performance; or

  b) can be used as a proxy for lack of historical performance information.

- the circumstances in which 'simulated' data for past performance might be used.

2.1.1 Presentation of past performance with a bar chart

8. CESR members discussed the merits of prescribing the exact size and format of the bar chart. It was agreed that there should be a general requirement of legibility, and that the past performance section should take up no more than half a page of the KID. Members also agreed to recommend standards of good practice regarding fair presentation of graphs, including specifications for the scale and axis.

9. It was agreed that the bar chart should not be required to show a negative scale on the Y-axis if there was no negative performance. There was also a discussion of whether the positive and negative portions should be symmetrical (e.g. if +90% is shown, -90% must also be shown). This might help investors realise that negative performances are possible even if they have not materialised in the past. As only one Member State expressed support for this suggestion, and in recognition of the fact that many funds are designed to achieve only low positive returns, it was agreed not to retain this proposal.

10. While some Members insisted on comparability and required a fixed template showing slots for the last 10 years for that purpose, others were concerned about very few funds being able to show such a long track record.

11. CESR recommends that:

- The size of the performance bar chart should allow for legibility but should not exceed half a page in the KID.
- The Y-axis scale should be linear, not logarithmic. The scale used should be adapted to the span of the bars shown and should not compress the bars so that fluctuations in returns are hard to distinguish. The X-axis should be set at the level of a 0% performance.
- Funds with a track record of 5 years or more should use a presentation template showing slots for the last 10 years.
- Funds with a track record of less than 5 years should be allowed to use a presentation template with slots for the last 5 years only.
- In both cases, appropriate layout should ensure that investors are not likely to mistake years where past performance is not available, with years where past performance was 0% or very close to 0%. This could be done by adding to each bar a percentage label indicating the return that was achieved (see 'Good Practice 2' below for an example).
- A general reference should be included in the explanatory text recommending investors to consider their own tax circumstances before investing.
- For 'no-load' funds, there is no need to include a reference to entry/exit fees.

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?

2.1.2 Past performance calculation

12. CESR saw merit in clarifying some harmonised calculation rules for the past performance shown in the KID to improve comparability. Further technical work has been undertaken in this area, as set out below.

Inclusion of fees

13. CESR favoured having a clear and prominent warning regarding charges and fees included or excluded from the calculation of past performance. The following wording was agreed:

'The past performance shown takes account of all ongoing fund charges, [and where relevant] but not the entry / exit fees.'

14. It was agreed not to cover tax issues in this part of the KID. When drafting its first advice, CESR discussed at length the opportunity to warn investors about tax issues in the KID and decided to test the added value of a warning on the possible impact of the taxation of the fund in the home Member State. A general warning about the taxation of savings revenue was not favoured since this would depend too much on the personal status of the subscriber, and of his or her state of residence. Furthermore, tax issues should be discussed with a financial adviser.

Currency

15. CESR agreed that the currency of the NAV should be repeated in the past performance section of the KID. This would not overload the information provided and would prevent any misunderstandings in the cases of cross-border selling and foreign underlying assets.

16. It would not be necessary to convert the past performance of a foreign fund into the local currency to reflect the position of the local investor. This would be detrimental to the smooth functioning of the cross-border notification procedure and should therefore not be allowed.

Selecting the NAV date for the performance calculation

17. It was agreed that, where the NAV had not been calculated on the last day of the year, the figure for the closest preceding available date should be used instead. This may also require the date considered as the first day of the year to be shifted backwards in order to keep a time period of a calendar year.

Treatment of income

18. CESR agreed that past performance information should be displayed on the assumption that any distributable income of the fund has been reinvested. However, it may not be necessary to flag this through a specific warning since it may not be understood by 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, the 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?

2.1.3 Impact and treatment of material changes

19. Material changes to a fund's investment objectives or policy may significantly affect the information contained in a past performance presentation. Member States have developed divergent approaches to material changes of this kind:

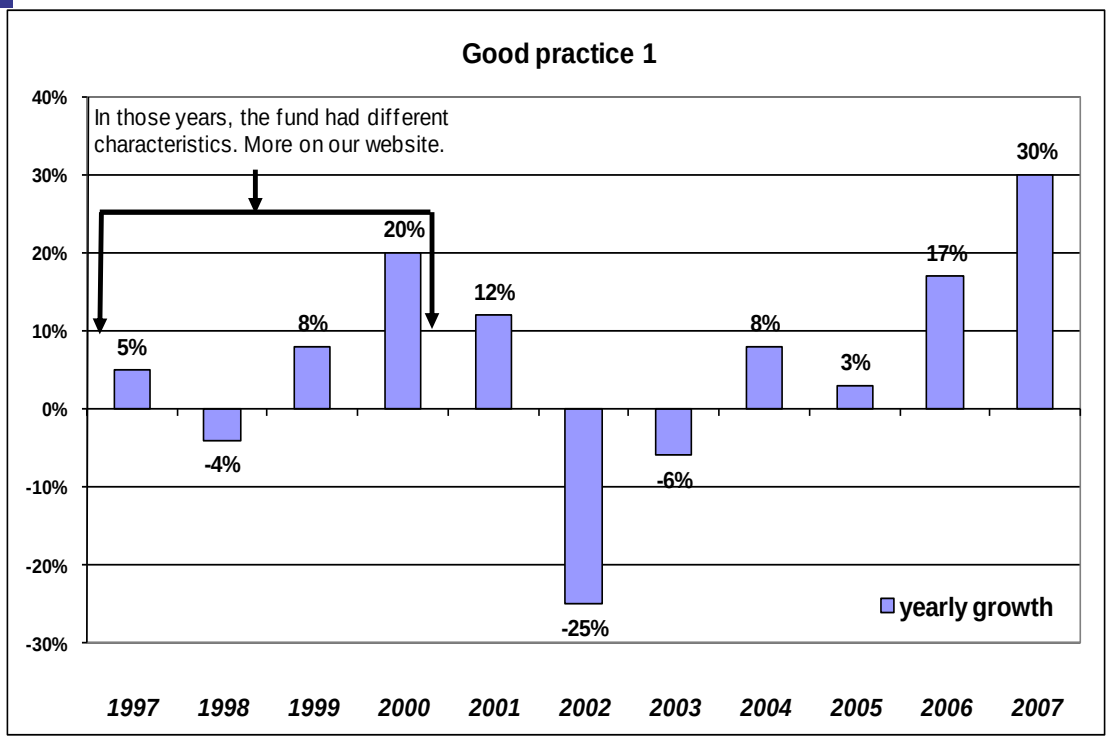
- Most Member States consider that this information is still meaningful in relation to the overall performance and consistency of the management company; such a 'reset of performance' is therefore not allowed, in order to discourage easy deletion of information.

- In a few Member States, deletion or disclosure of information is authorised in some circumstances and under the supervision of trade associations, as long as the overall presentation of the information is 'fair, clear and not misleading'. This is on the grounds that such performance is no longer relevant to the fund's profile and would therefore be meaningless, or even misleading.

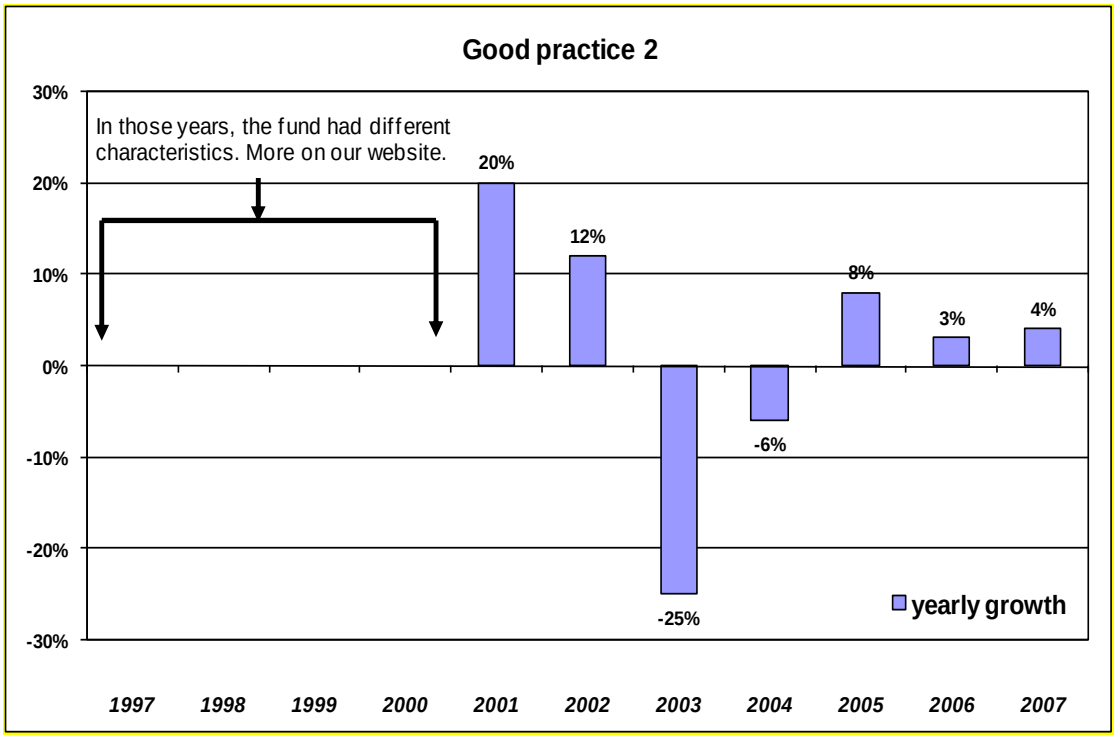
20. It appears, therefore, that Member States and data providers have developed quite different approaches regarding 'material changes'. Taking this into account, CESR discussed the opportunity and feasibility of issuing harmonised guidelines. The majority of Members agreed that it would be useful to issue such guidelines but views differed on whether this would be feasible within the current time frame. In particular, it was made clear that harmonisation might be a demanding and time-consuming task that might not be achievable at CESR level. For that reason, CESR agreed that the issue of material changes should be addressed as far as possible independently from other related topics at national level.

21. Consequently two examples of good practice have been envisaged:

Good Practice 1: this option maintains, with an adequate warning, the display of past performance that occurred prior to a material change:



Good Practice 2: under this option, removing past performance information would be authorised but under the condition of specific disclosure. The fact that part of the track record is absent would be flagged to investors to make them aware of the 'lack of consistency' on the part of the management company.



22. In light of the above, CESR considers that past performance that was achieved prior to a material change may be treated in either of two ways:

a) it can be retained, with a prominent warning included in the performance bar chart that it was achieved in circumstances that no longer apply (see Good Practice 1); or

b) it can be deleted, provided the bar chart is annotated to explain the reason for this, signposting to other sources of information if necessary (see Good Practice 2).

23. CESR is seeking views on whether to keep one option or both as good practice in order to ensure fair comparison between funds, noting the risk of lack of harmonisation within the EU.

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 of 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 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?

2.1.4 Conditions under which inclusion of a benchmark alongside the fund performance can be allowed

Inclusion of a benchmark

24. CESR agreed that a benchmark should not be required unless the objectives and strategy section of a KID makes reference to a benchmark, as set out in the initial advice.

25. Some argued that it would be technically possible to compel management companies to select and disclose a benchmark in every case and that this would be useful for investors for comparison purposes. Others made the point that this would not be relevant in all cases. Some Members considered that such a benchmark would have very different meanings depending on fund types, which would create a risk of misunderstanding by investors. It was thus agreed that a benchmark would not be made mandatory in all cases.

26. Members agreed that in instances where a performance fee is calculated by reference to a benchmark, but that benchmark is not mentioned in the strategy and objectives of the fund, the KID should not require the benchmark's performance to be displayed. Members noted, however, that in most cases the benchmark used in the calculation of a performance fee would also be mentioned in the strategy and objectives section, so that its performance would in practice be displayed.

Choice of a benchmark

27. Members considered whether CESR should deliver guidelines regarding the choice of a benchmark in the section of the prospectus describing the investment objectives and policy of a UCITS. However, it was agreed that this would be out of the scope of the current work on the content of the KID, and would be left at this stage in the hands of national regulators.

Treatment of income in benchmarks

28. It was discussed whether the current position in the CESR advice (i.e. that where the fund reinvests income, any linked index or benchmark should be shown on the same basis) would give sufficient guidance in all cases. It was considered that even if the advice was not clear as regards what happens when the fund does not reinvest income, there was a clear incentive for firms to show any linked index or benchmark on the same basis, so that it was unnecessary to be more specific. It was agreed that no further specifications were needed beyond the current CESR advice.

29. The group also agreed that it should not look to resolve any difficulties that might be raised by the impact of taxation on the fund or the investor, for the reasons noted in paragraph 14 above.

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?

2.1.5 'Simulated' data for past performance

Use of a benchmark as a proxy for performance data

30. Some funds may not have past performance data over the required five or ten years. In these cases, a proxy could be used to represent the fund's past performance i.e. the benchmark that the fund strategy is intended to pursue. In considering whether to require or permit the benchmark's performance to be displayed for the years before the fund existed, CESR took into account the following points:

- Pros: showing the evolution of a benchmark conveys at least a sense of the volatility of the asset class or asset mix targeted by the fund, which is better than showing nothing at all.

- Cons: investors risk mistaking the benchmark's performance in the past for the actual performance of the fund, without a proper understanding of the possible drift between the fund and its benchmark. In other words, newly launched funds could be sold on the basis of the past performance of some asset classes, without having proved their ability to properly track it. In order to mitigate the risk that investors mistake benchmark performance for actual performance of the fund, an appropriate warning may not be sufficient. Thus, an additional safeguard could be provided by specifying that only those funds that do have a track record of their own would be allowed to display benchmark performance for the years before the fund existed.

31. CESR recommends, therefore, that displaying a benchmark as a proxy for past performance for years in which the fund did not exist should not be allowed.

Questions for the consultation

38. Does the proposed recommendation rejecting the use of a benchmark as a proxy for non-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 of the fund?

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

Track record extension

32. In some cases, such as the creation of a new share / unit class alongside existing classes, or the creation of a feeder fund linked to an existing master fund, management companies might wish to show a simulated past performance by applying the conditions of the new class or fund to the past performance of the underlying assets.

33. In some Member States, track record extensions are managed through self-regulatory organisations that rely ultimately on the assessment made by data providers. In most Member States though, regulators would consider themselves directly responsible for the relevance of track record extensions and would either ban such extensions in the KID, or apply strict requirements.

34. Members agreed to consider an 'open approach' where this would be possible under some specific circumstances provided certain conditions are met. Most Members favoured an approach where continuity of the strategy and objectives between two funds is ensured not only by an assurance from the asset management company but is the consequence of a legal connection between the fund wishing to extend its track record and the fund from which this extension would be derived.

35. In the case of master-feeder arrangements and new share classes, there may be a built-in guarantee that the performances will be closely linked, insofar as the new share class or the feeder are, by design, invested in the same assets as the other class / fund. A track record extension can be envisaged as long as the characteristics of the feeder fund or new share class do not result in a change compared to the original fund / class. In order to assess this, reference could be made to the concept of material change as expressed above.

36. If the only difference between the feeder and master were the existence of a minimal pool of cash in the feeder to manage the subscriptions and redemptions, a track record extension would be considered permissible. However, in the case of a feeder investing only 85% of its portfolio in the master, with the remaining 15% invested in financial instruments offering the ability to modify the fund's characteristics (the draft UCITS IV Directive opens this possibility), it should not be permissible to use the past performance of the master. Similarly, a new share class offering a different currency hedging policy to other fund classes could not refer to the past performance of those classes.

37. In the case of 'parent and child' or 'predecessor and successor' funds, there is merely a commitment by the asset manager of the new fund to mirror the strategy of another fund. When it comes to 'parent and child' funds, there can be ongoing monitoring of this commitment by data providers, since both funds continue to exist; but it would be difficult

for regulators to carry out such monitoring. As regards 'predecessors and successors', this monitoring appears to be more difficult since the original fund ceases to exist, although data providers have developed processes to address this. It is noted that mergers through dissolution and creation of a new fund, which would be allowed under the new draft Directive, would be comparable to a predecessor and successor scheme to that extent (see paragraph 46 below).

38. However, many Members acknowledged that when a fund simply changes its legal form - for instance from contractual form to company status for tax reasons - track record extension might also be allowed.

39. This should not open the door to track record extensions in all cases of parent and child or predecessor and successor schemes on the grounds that they all imply a change of legal status. In particular, in some Member States, a change of legal status might trigger other consequences, including tax issues. Moreover, it would be difficult for one Member State to determine whether a new fund asking for authorisation should be allowed to claim the performance of another fund originally located in another domicile. In addition, in some Member States it is not possible to change the legal status of a fund. However, some Members favour an even more open approach where track record extension could be allowed even if the fund changes domicile.

40. Members agreed that the handling of track record extensions in past performance sources other than the KID may be based on different requirements carried out by data providers, provided the conditions set out under MiFID are met.

41. Therefore CESR recommends that:

- Track record extension i.e. the simulation of past performance for the years before a fund existed, should be permitted in the KID in the following circumstances and under the following conditions:

  a) a new share class of an existing fund or sub-fund may simulate the performance of another class, provided the two classes do not differ materially in the extent of their participation in the assets of the fund;

  b) a feeder fund may simulate the performance of its master, provided:

     i) option 1: the feeder fund's strategy and objectives do not allow it to hold assets other than units of the master and ancillary cash; or

     ii) option 2: the feeder fund's characteristics do not differ materially from those of the master.

- A fund changing its legal status in the same Member State may retain its performance record, to the extent that the competent authority of the Member State can reasonably assess that the change of status would not impact the fund's performance.

- In all cases, following MiFID standards, there should be prominent disclosure in the performance bar chart itself that this performance has been simulated.

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 CESR's approach that track record extension should be allowed when a 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.

Fund mergers and track record extension

42. Evidence shows that management companies tend to merge funds with a poor track record into funds with better past performance. Unit holders of the disappearing fund(s) are sometimes confronted with a display of past performance which does not reflect their actual experience. At first sight, this might not be a big issue since the KID is primarily meant to help future investment decisions, and not to serve as an ongoing information tool for an investment made in the past.

43. However, the overall assessment of the quality of the asset management by unit holders browsing through the range of funds operated by a management company might also be biased, since poorly-performing funds disappear without leaving any trace. Thus, Members considered that the current situation is also unsatisfactory as an aid to the decision-making process. Simulated past performance could help in solving this problem.

44. Three possibilities can be envisaged, each with pros and cons:

    a) Requiring the absorbing fund to display its own past performance record together with the past performance of any absorbed fund(s). This would be an accurate description of what happened. A display of different performances within 2 pages might be difficult, however, and the display of the performance of several absorbed funds in the same table might not be easy to read.

    b) Requiring the absorbing fund to compute an 'average past performance' taking into account the past performance of the absorbed fund(s), which would be easy to read as there would be only one performance to display.

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

In the case of a merger through absorption, CESR recommends that only the past performance of the absorbing fund (option (c) above) would be maintained in the KID.

45. CESR considered whether a disclosure to investors, such as 'On date YYYY/MM/DD the fund X absorbed fund Y', would be effective. Yet as mentioned before, this information does not seem likely to help investors to make a better-informed decision. It is not essential for investors, when deciding whether or not to invest in the existing fund, to know that it has previously absorbed other funds. The information should nevertheless be available through other sources (prospectus or website).

Mergers through dissolution and creation of a new fund

46. Members also discussed the case of mergers through dissolution and creation of a new fund and saw similarities with predecessor and successor schemes. Although it is understandable that the management company might want to maintain one track record irrespective of how the merger occurs, due to national practice, there is a risk of manipulation if a track record is allowed in that case. Members decided to flag this issue for consideration by the Commission.

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?

2.2 Funds for which past performance or a proxy cannot be used (structured and guaranteed funds)

47. In its initial advice to the Commission, CESR noted that past performance was not adapted to all types of funds, especially for structured funds[5] such as formula funds, capital protected funds and comparable funds. These funds raise specific concerns regarding the type of information which must be disclosed to investors and the corresponding illustration techniques.

48. CESR acknowledges that some Member States have implemented specific disclosure requirements in their regulations aimed at conveying a better understanding of the risk and reward trade-offs for structured funds. CESR considers that there should be an assessment of whether such presentations help investors' understanding of possible payoffs of such fund types. CESR recommended a choice between the presentation of:

a) back-testing data, showing how the fund would have performed under historical market conditions.

b) prospective scenarios showing the return of the fund under either favourable, adverse, or average market conditions;

[5] 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.

c) tables showing the probability of certain defined events (achieving a negative return or achieving a positive return worse, equal to or better than the risk-free rate);

2.2.1 Option A: back-testing

49. The 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.

50. CESR has considered the advantages and drawbacks of such an approach. The merit of back-testing is that it provides potential investors with examples of the gains or losses of the fund under certain historical market conditions.

51. However, several drawbacks have been identified in this methodology. Tentative findings from Phase 1 of the Commission's consumer testing exercise show that, out of the 3 formats tested, back-testing was misunderstood more than the other variants. There is a risk that investors might misunderstand the examples given and interpret past figures as future performance. Furthermore, CESR had noted the risk that a presentation using back-testing might easily be 'gamed' by tailoring the fund formula in order to present flattering data.

52. After careful consideration, CESR recommends not taking forward such an approach.

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?

2.2.2 Option B: prospective scenarios

53. The use of prospective scenarios involves calculating the expected return of the fund under either favourable, adverse, or average hypotheses regarding market conditions (this approach is generally referred to as the 'what if?' representation). The methodology is based on the application of the formula on which the fund functioning is based, to certain market conditions that would trigger a positive, neutral or zero return for the investor. This is intended to give the investor a better understanding of how the fund works by providing a simple answer, in the form of examples, to the question 'how much would I get if a certain event happens?'.

54. The different scenarios, which should ideally be differentiated as much as possible in order to cover contrasting outcomes, can be presented as either a graph or a table. Examples of the two approaches to presentation can be found in Annex C.

55. CESR has considered the advantages and drawbacks of using prospective scenarios.

56. Prospective scenarios would represent information which is complementary to and consistent with the information addressed in other sections of the KID. The examples could illustrate helpfully how a (relatively complex or sophisticated) fund will work in practice. They may also be a suitable way of providing investors with a meaningful representation of the risk and reward profile of the fund, notably any 'tail' risks described in that section. Findings from the first phase of consumer testing show that prospective scenarios lead to a good level of understanding by investors.

57. Prospective scenarios are already used in several Member States. They would be easy for UCITS providers to implement at limited cost and easy for regulators to enforce.

58. The scenarios should be straightforward and could be selected to illustrate how the fund would function in extreme market conditions. The scenarios could be ones that an average investor would not have previously considered. Including a worst-case scenario would allow investors to understand whether or not there is a guarantee or a capital protection.

59. However, concerns have been expressed that prospective scenarios could be misleading for investors. Scenarios should not, for instance, cover only favourable scenarios or imply a guarantee of future performance.

60. CESR recognises that, in order to ensure comparability of funds, there will have to be consistency in the choice of prospective scenarios used. In order to achieve this, it may be necessary to issue more detailed guidelines in order to foster a more harmonised approach to selection of the scenarios.

61. CESR formed the view that a table would be more understandable than a graph. It allows easy comparison with possible outcomes from investment in a risk-free asset which is a clear illustration, for instance, of the hidden costs of investing in a guaranteed fund. Also, presentation in the form of graphs raises a particular challenge to CESR's objective of limiting the whole document to a maximum of two sides of A4.

62. CESR therefore considers that on balance it is worth pursuing the option of prospective scenarios. However, it is necessary to retain only one approach to presentation – either graphs or tables. The Commission is conducting a second phase of testing that will inform this debate.

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 comprehensible from the investor's perspective? Is there any technical feature which may 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?

2.2.3 Option C: performance scenarios based on probability tables

63. CESR considers that an alternative option, involving the use of probability tables, should also be assessed.

General presentation

64. As explained above, structured funds typically promise predetermined pay-offs at given dates (a fixed investment horizon), which may depend on certain parameters, such as the return or the volatility of a financial index.

65. Consequently, assumptions can be made about the processes that determine the evolution of these parameters to enable a fund's value to be calculated at the end of its given time horizon or, alternatively, for a full set of possible trajectories of the fund's value to be simulated if the above-mentioned processes are assumed to be stochastic in nature (that is, subject to random deviations).

66. While the distribution of simulated performances already provides details about the potential reward offered by the fund, investors' ability to make use of such information may be seriously hampered by its inherent excess of granularity. A table can be constructed to sort the data showing the possible performances of the fund, according to their correspondence to four[6] major events: (1) the return of a negative performance; positive results of returns (2) lower, (3) in line with, or (4) higher than those which could be achieved by investing in risk-free assets. The four performance scenarios are illustrated in the table below.

Example of a probability table

EVENTS	PROBABILITY
The performance of the fund is negative	10 %
The performance of the fund is positive but lower than the return from an investment in risk free assets over the same time horizon of the fund	20 %
The performance of the fund is positive and in line with the return from an investment in risk free assets over the same time horizon of the fund	40 %
The performance of the fund is positive and higher than the return from an investment in risk free assets over the same time horizon of the fund	30 %

Methodology for computing probabilities

67. To compute the simulations needed to quantify the probabilities of the performance scenarios, it is desirable to establish a set of binding, but still sufficiently flexible, methodological requirements, which translate general principles of correctness, accuracy and prudence regarding the outcome of the disclosure. Such requirements allow for the use and implementation of a large array of models and computational techniques, that are broadly reflected within the pricing, hedging and general risk management processes and systems adopted by most asset management companies.

[6] An additional fifth event is the realisation of conditions that activate a guarantee, if this is established by the rules of the fund. In these circumstances, the event included in the performance scenarios table would capture those cases when the performance of the fund, which would be per se negative (or at any rate below the target), can be taken as equal to zero (or to another predetermined value) because of the intervention of the guarantee.

68. The following steps would be required to apply the methodology outlined above:

i) Identify the underlying financial variables and techniques that are relevant to the investment strategy adopted by the fund.

ii) Define the processes that are assumed to govern the evolution of the variables identified at the previous step, and calibrate their parameters.

69. Models should be identified and calibrated with due regard to the pricing, hedging and general risk management processes and systems employed by fund management companies. This will not only enable synergies of costs and expertise (economies of scope) to be achieved, but should ensure that the accuracy of the disclosure is maintained over time because of a true matching with the characteristics of the fund, and as a result of a solid integration with management, pricing and control structures and procedures.

iii) Simulate the performances of the fund over the appropriate (often pre-determined by the formula/algorithm) investment horizon and under the risk-neutral measure.

70. Fund performances should be simulated taking a risk-neutral approach. This approach offers clear advantages from both a regulatory and a supervisory perspective, as it meets a general criterion of prudence with respect to the simulations of the performances of the fund and does not require data for the average returns of assets (that is, it avoids the issues linked to the equity 'risk-premium'), whose estimates may widely differ according to the sample period being analysed or to the subjective judgment of those who perform the simulation.

71. Furthermore, the adoption of a methodology based on risk-neutrality appears perfectly consistent with the pricing and hedging tools ordinarily used by asset management companies and, in general, by financial intermediaries in their proprietary activities. In conclusion, the adoption of a risk-neutral perspective is justified by the same nature and objective of the content disclosed in the table, which represents only an alternative, equivalent and more complete representation of the information contained in the price of these products at the time of their offering.

iv) Simulate the returns from investments in risk-free assets over the same holding period of the fund as was identified according to the previous step.

72. The distribution of risk-free returns at the end of the holding period of the fund should be simulated in the same way, as risk-free rates are also subject to movements that can be modelled as stochastic processes.

73. To calibrate these processes, relevant parameters would need to be set at values which, at least, should be consistent with those applied to the models used for simulating the performances of the fund.

74. In particular, it should be noted how the elaboration of the estimated risk-free rate into the computation of the fund's performance at each step of the simulation may represent a very effective solution to address the difficulty of capturing the correlation between the equity and the interest rate risk factors.

v) Perform a probabilistic comparison of the possible performances of the fund with the returns that could be achieved by investing over the same holding period in risk-free assets.

75. As already explained, the distributions of fund performances and of risk-free returns are compared by means of four scenarios (events), where the risk-free returns play the role of terms of reference to classify the performances predicted for the fund.

Merits and limits

76. Feedback from the consultation suggested that out of the three options, the table showing the probabilities corresponding to different possible performance scenarios for the fund seemed to fare slightly better in terms of the level of clarity it offered investors.

77. Probabilistic performance scenarios may be a suitable way to provide investors with a meaningful risk and reward disclosure. Investors might easily grasp the content of the information that the table conveys. It would be complementary to, and consistent with, the other KID sections. The option would not be difficult for UCITS operators to implement and would not introduce any additional liability for them. It would help clarify the limits of the responsibility attached to the disclosure of the risk and reward profile of the fund in the prospectus or KID.

78. However, the use of probabilistic tables also presents drawbacks:

- The computation of probabilities of the performance scenarios implies the use of assumptions and models, which increases the risk of errors.
- Investors might misinterpret the figures displayed in the probabilities table, focusing only on the probability of favourable scenarios or taking them as a guarantee for future performance.
- Exposures to particular (rare and extreme) events are not better explained to investors through their impact on the performance scenarios. This is due to the fact the probability table does not describe the shape of the distribution of potential returns; however, since this distribution must be estimated through the simulations, the impact of rare and extreme events could always be captured as far as the conditional expectations of the performances of the fund corresponding to each of the scenarios are also displayed.
- While comparison of likely fund performance with returns of a risk-free asset is still possible, it is not improved or better presented than with other options.
- There are concerns regarding the ability of regulators to monitor the application of probability tables, taking into account the availability at the supervisory level of the specific technical and human resources needed to verify the correct implementation of this approach.
- The table lacks information about the size of possible returns associated with each of the four events (the performance scenarios). The aim of keeping the information disclosed in the table simple and immediately understandable prevents the representation from capturing details linked to the specific shape of the distribution of the potential returns.
- For funds which are actively managed, it may not be reliable to represent the contribution of the management style to fund returns of different funds.

79. CESR considers that this avenue might be further explored. The European Commission is conducting a second phase of testing that will feed into this debate.

Questions for the consultation
54. Are the methodological requirements which underpin probability tables sufficient,

clear and appropriate?

55. Would such an approach cover all types of fund 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?

CESR

CHAPTER 3

Charges

1. The Level 1 measures (Article 78 (3)) of the draft recast of the Directive will require that:

   'Key investor information shall provide information on the following essential elements in respect of the UCITS concerned: [...]

   d) costs and associated charges [...]'.

2. As stated in CESR's previous Advice to the Commission, information about charges is crucial for investors making investment decisions and provides a basis for investors and their advisers to compare different products. Despite the importance of charges, evidence suggests that consumers can misunderstand even relatively simple information about charges. In response to these problems, the Commission indicated a number of options it wished CESR to explore in its proposals for KID:

   - the development of a summary figure (i.e. a total expense ratio (TER) or similar figure) to show overall fund charges;
   - the elaboration of options for the presentation of the overall effect of all the charges in cash terms; and
   - the exploration of options for a summary figure suited to comparisons, summarising all charges the investor is likely to face, including entry and exit charges.

3. This chapter recaps the main points of CESR's Advice to the Commission to pursue two options for the presentation of charges and explains the results of the first phase of consumer testing of those options. This is followed by analysis of the issues relating to the underlying detailed methodologies supporting the figures shown.

3.1 CESR's recommended options for consumer testing

4. CESR identified two high-level options to be tested with consumers for the presentation of charges – one of them an improved version of the existing Simplified Prospectus disclosure, the other giving the same improved information with the addition of a single 'summary' figure.

3.1.1 Option A – an improved version of the current approach

5. This option focuses on improving the presentation of existing charges disclosures and rationalising the information shown, by:

   - outlining separately the charges paid by the investor, ongoing charges paid out of the fund's assets, and contingent charges such as performance fees;
   - showing clearly how the different charges fit together;

- removing information which is irrelevant to the average retail investor or which is covered by other disclosed charges; and

- clarifying what the disclosed charges do and do not cover.

6. This option aims to expose the elements of the charging structure as clearly and simply as possible and investors will have to consider for themselves the combined impact of the charges and how those charges might apply to a particular transaction or pattern of transactions.

3.1.2 Option B – the addition to Option A of a summary measure of charges

7. This option tests whether a prominently presented disclosure, combining into a single figure both the charges borne directly by the investor and the ongoing fund charges, helps consumers to grasp better the overall effect of multiple charges. The option supplements the detailed disclosures included in Option A, rather than replacing them entirely. Two ways of presenting the combined charges figure have been devised: one that uses percentages, and the other showing figures in terms of cash.

8. In its Advice to the Commission, CESR recommended concentrating on presentations using percentages. However CESR also noted consistent support from consumer representatives for testing a presentation showing cash figures. As a result, both variants have been tested with consumers to help determine which presentation investors find more effective.

3.1.3 Consumer testing

9. In the first phase of the Commission's consumer testing on charges, investors were presented with different examples providing information on fund charges.

10. The first example was a 'short' version of the explanation which included information on performance fees. 70% of investors rated this example as clear in outlining charge descriptions. However, nearly a quarter stated there were elements in that example they did not understand, chiefly the charges themselves. Uncertainty about charges was further seen in investor responses to some of the true/false statements, where 3 of the 8 statements received nearly equal true/false responses:

    - Investors seemed unclear about the entry charges and whether ongoing charges represented all charges paid during the year.

    - Better understanding was seen regarding variation of ongoing funds each year, and the impact investment growth has on charges.

    - Only 38% could correctly calculate the amount of charges they would pay over a 5-year period.

11. Investors were also presented with another 'short' version, which did not include information regarding performance fees. Using this example:

    - 43% of investors felt confident in their ability to distinguish between the charges for the funds in each example; 23% were not confident.

    - The majority of investors were able to correctly answer questions on information contained in each version, particularly regarding entry and ongoing charges. Only a slight majority was able to determine which fund/version would cost them the most after cashing the investment after a period of time.

- One third of investors were able to answer all questions on comparing both examples correctly.

12. As a comparison to the 'short' version, investors were shown variant examples that contained a section called the 'Illustration of the Charges'. One example was presented in text format, expressing charges as a percentage, and the other contained a table format expressing charges in monetary figures. The results of that testing revealed:

- Clarity levels were somewhat higher for the table example; 66% of investors found that the inclusion of the table made the overall description of charges clear, compared to 58% reviewing the text version.

- There were few statements about the table example that the majority of investors were able to correctly determine as true or false.

- Over half of investors viewing either the text or table variants believed the purpose of including the illustration of the charges is to help the investor estimate the overall amount you might pay in charges.

13. When asked to determine the amount of charges that would be payable if 10,000 euros were invested for a period of 5 years, both the table and text variants elicited the same level of correct response. Additionally, the majority of investors comparing different explanations of charges preferred the table example. They responded that the table variant was clearer, enabled easier comparison, and included all the information needed.

3.1.4 Next steps for evaluating the options

14. The conclusions that CESR has drawn from these responses are that:

- there is sufficient support for a summary measure of charges (Option B) to continue consideration of this option, without entirely ruling out Option A at this stage;

- regarding the variant presentations of Option B, investors appeared to prefer the table version of the illustration of charges over a text version;

- notwithstanding the previous bullet, the table version did not add to the ability of investors to correctly answer statements about the fund shown.

15. At this stage, CESR has not prepared a detailed methodology for calculation of the illustration of charges; an outline procedure for the table of cash figures is set out in Annex A of this chapter. A table of cash charges, in particular, would require assumptions to be made – at the very least, the growth rate, the future level of the charges and the level of entry charges levied. These assumptions might be difficult for investors to understand.

16. Although CESR has acknowledged in its draft Advice that a number of issues exist in regard to showing an illustration of the charges, the results of the first phase of the Commission's consumer testing have provided evidence that investors understand the purpose of the illustration and are able to use it to determine the overall charges. The second phase of consumer testing is carrying out further analysis on both variants of Option B, which will enable CESR to proceed to a recommendation in its final Advice about whether to use one or the other of these variants, or to revert to Option A.

Questions for the consultation

58. Do you think a summary measure of charges 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?

3.2 Overall presentation of charges

17. CESR's advice (paragraphs 7.22 to 7.25) noted some of the issues that would arise from using a single 'ongoing charges' figure to replace the existing TER. It is necessary to consider whether such a figure should be based on ex-ante or ex-post figures, or a combination of both. An ex-ante presentation uses figures which are either estimated or known to be the ones that will apply in future, whereas an ex-post presentation uses only figures that have actually applied in the past.

18. CESR's general preference is for an ex-post methodology because:

- an ex-post approach is relatively easy to explain and to supervise (using audited fund accounts), and relatively easy to apply consistently to funds as an overall measure of fund costs;
- such a methodology has been strongly supported by the industry and can build on the existing TER methodology.

19. A number of issues regarding the details and viability of an ex-post methodology have been discussed by CESR. There is concern, for example, that investors should be able to use figures provided in the KID as a good guide to future charges, and that in some circumstances ex-post figures would not necessarily be such a good guide.

20. The following possible alternative approaches have been identified:

i) Option 1 – show the ongoing charges figure based on ex-post figures.

ii) Option 2 – as Option 1, but show additional ex-post data for multiple years alongside or as part of the past performance graph.

iii) Option 3 – show the ongoing charges through two figures rather than one – an ex-ante estimate and an ex-post figure.

21. The following table analyses the benefits and drawbacks of each alternative.

Benefits	Drawbacks
Option 1	
• Simplicity of presentation • Offers a single focal point	• Investors may not understand that the total amount of charges can vary from one year to another
Option 2	
• Shows information about the magnitude of charges across different periods alongside performance data, providing a useful context to understanding the magnitude and impact of these charges • May offer a useful compromise between	• Likely to make past performance presentation too complicated for many investors • May reduce investor's perception of the cumulative impact of charges or their significance (as they may seem

the inclusion of more information, and the provision of that information in a way that investors can use.	small when plotted against data showing strong performance)
Option 3	
• Relatively simple presentation of forecast and ex-post figures • Allows figures for last year's performance fees to be shown • Showing both ex-ante and ex-post may communicate more clearly that charges can vary (than a label as under Option 1)	• Has a less clear focal point • Investors may fail to make appropriate distinctions between the ex-post and ex-ante figures (there may be very little difference between them) • Investors may take the ex-post figure to be a composite 'overall' charges disclosure when in fact it excludes initial or exit charges • A single ex-post figure inclusive of performance fees may be misleading given their potential year-on-year volatility

22. The view of the working group was that Option 2 was likely to prove too complicated for investors to understand. Some CESR members favoured Option 3, but the majority view, supported by representatives of industry and service providers, was that Option 1 is best suited to a short and simple document such as the KID is intended to be. CESR has considered the drawback to Option 1 noted above, that investors might not understand that charges can vary from one year to another, and section 3.3.3 following deals with this issue.

Question for the consultation

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

3.3 Methodology for ongoing charges figure

23. CESR has developed a methodology for identifying which items should be included in the ongoing charges figure and harmonising the calculation of the figure. It draws on the methodology for calculation of the TER that forms part of the Commission Recommendation, but with some new elements. The use of the term 'TER' has been avoided as the figure does not purport to cover all the costs that an investor will bear. Industry representatives have noted that some elements of this methodology may require further consideration to determine whether they will work in all cases.

24. The proposed methodology is set out in Annex B; the chief points to note are that:

- there is a presumption that all costs borne by the fund must be taken into account unless they are explicitly excluded;
- performance-related fees and transaction costs are among the costs excluded from the calculation (as are entry and exit charges borne by the investor);
- an ex-post calculation based on audited accounts should be used wherever possible; and

- adaptation of the methodology is necessary where a new fund is to be launched, or where there is a significant change to the costs of an existing fund.

Further explanation of these points is given in the following paragraphs.

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?

3.3.1 Performance fees

25. In paragraphs 7.30 to 7.33 of the Advice, CESR recommended that where a performance-related fee may be charged to the fund in certain circumstances, it should not be included within the ongoing charges disclosure, but should be described briefly with signposting to the place where a full explanation of its operation can be found.

26. The working group gave further consideration to this issue, in particular how the three presentation options explained above might be modified to take account of performance fees. It was suggested that Option 1 could be modified by including an amount representing the performance fee as part of the ongoing charges figure. Consequently, CESR has refined Option 1 into Option 1a (excluding the performance fee) and Option 1b (including the performance fee), the pros and cons of which can be summarised as follows:

Pros	Cons
Option 1a: show ongoing fund costs as single figure excluding performance fees; no explicit figure for performance fees	
• Simplicity of presentation • Offers a single focal point	• No explicit figure for performance fees (though these are disclosed indirectly via net past performance data)
Option 1b: show ongoing fund costs as single figure including performance fees if they were actually paid	
• Simplicity / single focal point • Consistent with current practice for presenting TER in the simplified prospectus	• No explicit figure for performance fees • A single ex-post figure inclusive of performance fees may be misleading given their potential year-on-year volatility

27. It was also noted that Option 2 allows the possibility of showing specific data on performance fees that were charged, potentially for multiple years, as part of the past performance presentation. Option 3 would also allow data for the latest year to be included in the ex-post figure, potentially contrasting with the ex-ante figure which would assume no performance fee would be payable for the coming year.

28. The provisional conclusion of the group was that Option 1a is to be preferred on the grounds of simplicity and brevity. However, in order not to exclude entirely at this stage the possibility of giving some information about the actual performance fee charged, further analysis is needed. Some useful clarification on this should be provided through the results of Phase 2 of the Commission's consumer testing exercise, which will test consumers' comprehension of one presentation that includes an explicit performance fee figure (purporting to be the percentage charged in the last accounting period) and one that does not. Evidence of how consumers react to and interpret these alternative presentations will enable CESR to proceed to a final recommendation on this issue.

29. Given concerns around providing explicit information about actual performance fees in the KID, CESR recommends supplementing Option 1 (or the other options) with signposting to more detailed information. This information might include data from previous years showing the TERs/ongoing charges figures and actual performance fees charged to the fund. It might appear, for instance, in the fund's annual reports.

Questions 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?

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

3.3.2 Portfolio transaction costs

30. Portfolio transaction costs will, if passed directly through to the fund, almost always have an impact on its overall costs and thus on its investment performance. However, as noted in paragraphs 7.27 to 7.29 of CESR's advice, there are difficulties in ascertaining the specific amount represented by transaction costs. This is due to the current lack of transparency in relation to the implicit costs of certain transaction types e.g. debt securities. Including disclosures of transaction costs only for those assets where explicit costs might be readily obtained or calculated – notably equities – has the significant downside of treating different assets in an uneven way, which is likely to distort comparisons between funds.

31. The advice also recognised that the use of a portfolio turnover rate (PTR) is likely to be too opaque for the retail investor to interpret without a detailed explanation of its significance, and that such detail is not appropriate for the KID.

32. CESR notes that greater clarity and transparency is desirable in this area, but cannot easily be achieved without the support of firms on both the buy-side (investment managers) and sell-side (brokers and other execution venues). Further work might be considered to bring about improved disclosure, although this would probably need to be applied across a wider range of investments than just UCITS for the benefits to justify the costs. If satisfactory solutions can be found, information about transaction costs could be incorporated into the KID or related ancillary disclosures at a later date.

33. CESR also notes that information about PTRs and brokerage costs (where available), although technical and unsuited to a retail document such as the KID, is nonetheless a valuable aid to transparency in the wider market. It should continue to be published so that it is available to market counterparties, intermediaries and others who can make use of it. The proposed amendment to the Directive requiring publication of information on transaction costs in the reports and accounts of UCITS is likely to help support this aim, although it may require some harmonisation (possibly through future CESR guidance) to be effective.

34. In view of these considerations, CESR has not developed specific proposals for the detailed disclosure of portfolio transaction costs. CESR proposes that their potential impact on returns should be highlighted through a narrative warning in the charges section. Where the impact of these costs is likely to be material due to the strategy adopted by the fund, this

might be notified either within the sections of the KID describing strategy and objectives, or risk and reward, at the discretion of the UCITS operator. The second phase of consumer testing includes questions designed to ascertain whether investors understand the significance of these narrative disclosures.

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 certain circumstances, the strategy/objectives or risk and reward sections of the KID?

3.3.3 Circumstances where future charges might vary significantly

35. The choice of an ex-post methodology for calculating the ongoing charges figure requires the impact of variations in charges, from one year to another, to be taken into account. The nature of this impact will depend on the particular charging models that UCITS operators choose to adopt in relation to payments taken from the fund. The relative prevalence of these models may vary across different jurisdictions and markets.

36. The most common model is for the management company and other parties to the fund to be remunerated by an ad valorem fee. This is a fee based on a fixed percentage of assets under management, with the result that the actual amount payable will fluctuate as the market value of the assets moves up or down. There are three principal types of ad valorem charging:

- Charging a single fixed percentage rate to cover both the management charge and other expenses (though typically excluding contingent and transaction costs which are separately passed through to the fund);
- Setting and disclosing a maximum percentage charge (where the fund would aim to levy total charges below this ceiling, though not necessarily to guarantee this); and
- Passing through all charges (where the annual management charge is known and disclosed in advance, but no estimated maximum charge would be disclosed).

37. The latter two models pass fluctuations in the charges onto the client, whereas the first 'smooths' them, with the management company absorbing any surplus or shortfall in the actual charges incurred. Where a disclosed charging level might be subsequently exceeded, the magnitude of the fluctuations in the charges determines the extent to which these different models might raise particular disclosure challenges.

38. Fluctuations in overall fund charges may be due to the existence of a performance fee structure, the impact of portfolio transaction costs, or other charging elements that cannot be exactly predicted ex-ante. It can be argued that if there is a strong likelihood that a single charge disclosure might understate actual charges, then both ex-post and ex-ante figures should be included, so investors can consider for themselves the volatility of the charges. However, the importance of fluctuations in charges only becomes apparent as a result of longer-term volatility and it would be difficult and impractical to display several years' historical charging data in the KID.

39. CESR has agreed that a good working assumption is that overall variability in charges is largely due to the impact of performance fee structures (the cases of portfolio transaction costs and new funds notwithstanding), as the remaining variable costs should not differ

significantly in magnitude year-on-year. To the extent that this assumption is right, fluctuations in a disclosure figure which excluded performance fees would be of a lesser magnitude.

40. Given that, under some charging models, the total charges actually paid from the fund's assets may be higher (or lower) in one year than in the preceding year, CESR proposes to accompany the ongoing fund charges disclosure with a warning:

'The ongoing charge is based on the expenses for [the year being shown]. These can vary slightly each year.'

41. The warning would be included on the assumption that these variations are only slight. Where a significant variation is anticipated, an estimated ongoing fund charges disclosure would be required, as explained in the next section. The warning might be omitted where a flat fee structure is adopted.

Question for the consultation

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

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

3.4 Circumstances in which ex-post figures might be inapplicable

42. CESR recognises that in some circumstances, the use of ex-post figures will not be possible or appropriate. A new fund cannot, by definition, provide ex-post figures for the calculation of its ongoing charges. An existing fund may undergo a change in its charging structure that would render an ex-post calculation inaccurate and potentially misleading. This section explains how these situations might be addressed.

3.4.1 New Funds

43. The charging structure of a new fund will determine how its ongoing charges figure should be calculated. Of the three structures identified in paragraph 36, the first two are straightforward. For funds which charge a fixed, all-inclusive fee (i.e. where the figure is set at a level expected to cover all charges and expenses, and the management company absorbs any consequent profit or loss), that figure can be used; it will in effect be accurate both as an ex-ante and an ex-post disclosure. For funds which set a cap or maximum on the amount that can be charged, that figure will be the appropriate one to disclose if the management company gives a commitment to respect the published figure and to absorb any costs that would otherwise cause it to be exceeded. Again, so long as it is capped there will be no distinction between ex-ante and ex-post disclosures.

44. In all other cases, an ex-ante figure will need to be estimated, based on the expected total of charges. The following paragraphs set out CESR's initial thinking on the issues that need to be addressed for such estimates to be fair, clear and not misleading.

45. Fee payments on an *ad valorem* basis can either be taken into account on a pure ex-ante basis, or an attempt can be made to estimate their likely impact, based on a view of what the fund's average NAV might be over its initial period. CESR considers the first approach is preferable as it is simpler and less open to manipulation.

46. A more complex variation involves two or more tiers bearing different *ad valorem* fees. This is usually organised so that the first tier attracts the higher fee, with assets in excess of

that value paying a lower fee – in other words, a discount for volume. Where a tiered fee structure is in place, it should be assumed for the purposes of the calculation that the fees applicable to the lowest tier are charged, unless the UCITS operator has valid grounds for believing a higher tier will apply.

47. Flat fees are not of themselves problematic since they will clearly be fixed, although their impact on the disclosure figure will require an assumption to be made about the level of the fund's NAV, as discussed below.

48. Fees charged per transaction or per account (e.g. shareholder registration fees) can only be taken into consideration if estimates of the likely number of transactions/accounts are made ex-ante. For portfolio transactions, the investment manager should be able to make an estimate based on the fund's investment strategy and target assets[7]. For numbers of accounts, the manager may have experience of similar funds, or its administrator / transfer agent may be able to assist, based on experience with other funds.

49. During the initial period of a new fund's existence, there is an issue about the extent to which realistic assumptions can be made about the average level of its NAV. There are some situations in which predictions can confidently be made about initial assets under management:

- Where the first property of the new fund is to come from the transfer of assets from another fund (or funds) being wound up.
- Where there is a firm commitment for monies under the control of the operator or its associates to be transferred in (e.g. discretionary managed portfolios within the same group).
- Where the operator has a contractual commitment with a third party to manage that party's assets within the new fund (e.g. target fund for a fund of funds).

50. In each of these cases, it would appear reasonable for the anticipated level of investment to be used as a basis for estimating an average NAV. If none of them is applicable, the operator or an associate in its group may be willing to commit an amount of seed capital for a certain period. This may also be suitable for estimating the NAV, although it is more open to manipulation (for example, the money might be withdrawn so that the fund would contract in size and incur higher charges than are stated in the KID). If there is to be no seeding, a sensible assumption about the likely level of investment into the fund is required (this would need to be conservative i.e. not just a sales target).

Questions for the consultation

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

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

3.4.2 Material changes to charging structure

51. New funds are not the only cases in which a purely ex-post approach to calculating charges may be unsuitable. For a fund where a charge is to be (or has already been) increased, the

[7] As noted above, the UCITS operator should determine whether such costs would be material, even though no specific figure is disclosed.

effect of that charge will not be reflected in ex-post data for some time to come (e.g. when the annual management charge has been altered in the course of the fund's accounting year). Assuming the change is of sufficient magnitude to alter the overall figures materially, the continued use of the ex-post figure might in some cases be misleading to investors.

52. CESR has examined different options for addressing the risk that ex-post figures might be misleading:

- replacing the ex-post figure with an ex-ante figure appropriately adjusted to reflect the new expected level of charges;
- including an additional ex-ante figure in such cases only (though this would introduce inconsistencies in presentation between different funds and investors might find it difficult to interpret);
- adopting one of the other presentational options identified in section 3.2 for all funds (notably, Option 3 showing both ex-post and ex-ante figures); or
- using a narrative to warn that the charges level is anticipated to be higher (though investors might find it difficult to interpret the materiality and importance of this warning).

53. CESR considers that the first of these options will probably be the easiest for investors to grasp. Therefore, where an ex-post figure would be misleading due to material changes in the charging structure, or where historic data is unavailable (new funds), CESR proposes replacing an ex-post figure with an estimate. This change of basis should be clearly labelled.

54. CESR proposes the following wording:

'The ongoing fund charge shown here is an estimate of the charges for the next year. [Firm inserts short description of why an estimate is being used rather than ex-post figures.] The fund's annual report will include detail on the exact charges made.'

55. The calculation of the estimated figure would broadly follow that for new funds.

56. CESR has considered how far a harmonised position might be established as to what counts as a 'material' change. A number of regulators and industry experts have proposed that further clarification might be necessary.

57. It is reasonable to set some level of materiality in this area, otherwise a UCITS operator would have to update the KID every time it knows or believes one of the elements making up the ongoing charges figure has changed or will change. Such updates should happen only where there is, for example, an increase in the annual management charge.

58. Even so, it will be difficult to define materiality in terms of which element is changing – a fund could, for example, experience an immaterial change in its management fee but a material increase in its custody costs. A possible approach could be to express materiality in terms of a specific figure: for example, any variation of [x] basis points or more would be 'material'. However, a fixed amount would be far more significant for a tracker fund with average ongoing charges of perhaps 0.45% or 0.5% a year than for an actively-managed equity fund charging typically 1.5% to 1.75% a year.

59. Alternatively, the fluctuation could be expressed in percentage terms (e.g. a 5% variation in the amount is material, so an increase to an annual charge from 1% a year to 1.05% a year

would require a revision to the KID); but that would tend to understate the effect of change in a fund with high charges compared to one with low charges.

60. A combination of these elements might work but would be relatively complex to operate and would still require an element of judgment to be exercised by the operator or its regulator. This implies that the requirement might be best expressed as a principle, supported by guidance to ensure that a material change is identified and acted upon even if it falls within the specified parameters.

61. This issue might, however, be profitably considered alongside the handling of material changes more generally, for instance in regard to updating the KID where its objectives and strategy change or the annotation of past performance information. CESR notes that different jurisdictions operate different approaches to the general questions of 'material change' – for instance, in relation to objectives and strategy, some rely on industry standards while others have detailed rules relating to asset allocations. This matter will be considered further in the final consultation on CESR's advice to the Commission.

Questions 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?

Annex A

Methodology for illustration of charges

Illustration in cash terms

The following may be considered as a starting point for standardised disclosure of charges in cash terms:

- Assume a rate of return for the fund of [risk-free rate].
- Assume a single investment at the start of the period [€10000].
- Assume that all of the charges and expenses disclosed within the KID (other than performance fees, and entry charges if they are applied when reinvesting dividend income) apply and remain the same throughout the period being illustrated.
- Entry and exit charges should be included at the maximum level and applied on the basis that all units are acquired at the beginning of the period being shown and redeemed at the end of the period being shown.
- Assume reinvestment of all income (dividends or distribution).
- Should a fund have a minimum investment greater than €10000, then a narrative statement should be included that the minimum investment is greater than the amount being illustrated.
- The currency shown should be that of the fund or share class described in the KID, but a host Member State may not require funds being sold cross-border to convert the presentation to the local currency of that State.

CESR

Annex B

Calculation of the ongoing charges figure

The operator is responsible for the calculation of the ongoing charges figure and for its accurate statement in the KID. To this end, the operator must establish a methodology that is consistent with the rules and adequately documented.

Part 1 Definition of ongoing charges to be disclosed

1.1 In the context of the KID, 'ongoing charges' are payments deducted from the assets of a UCITS where such deductions are required or permitted by national law and regulation, the fund rules or instrument of incorporation of the UCITS, or its prospectus. The figure to be disclosed in the KID is based on the total of all such payments made over a specific period, excluding the exceptions identified in paragraph 1.4 below.

1.2 The ongoing charges should include all types of cost borne by the UCITS, whether they represent expenses necessarily incurred in its operation, or the remuneration of any party connected with it or providing services to it. These costs may be expressed or calculated in a variety of ways (e.g. a flat fee, a proportion of assets, a charge per transaction, etc.).

1.3 The following list is indicative but not exhaustive of the types of ongoing charge that, if they are passed as debits through the balance sheet of a UCITS, should be taken into account in the amount to be disclosed:

- all payments to
    - the operator of the UCITS
    - directors of the UCITS if an investment company
    - the depositary
    - the custodian(s)
    - any investment adviser;

- all payments to any person providing outsourced services to any of the above, including:
    - providers of valuation and fund accounting services
    - shareholder service providers, such as the transfer agent and broker dealers that are record owners of the UCITS' shares and provide sub-accounting services to the beneficial owners of those shares;

- registration fees, regulatory fees and similar charges;

- audit fees;

- payments to legal and professional advisers;

- any costs of distribution or unit cancellation.

1.4 The following charges and payments do not form part of the amount to be disclosed as ongoing charges in the KID:

- entry / exit charges or commissions, or any other amount paid directly by the investor (e.g. charges payable to distributors);

- a performance-related fee payable to the operator or any investment adviser;

- interest on borrowing;

- payments necessarily incurred in connection with the acquisition or disposal of any asset for the UCITS' portfolio, whether these payments are explicit (e.g. brokerage charges, taxes and linked charges) or implicit (e.g. costs of dealing in fixed-interest securities, market impact costs);

- payments incurred for the holding of financial derivative instruments (e.g. margin calls);

- the value of goods or services received by the operator or any connected party in exchange for placing of dealing orders (soft commissions or any similar arrangement).

1.5 The exclusion for transaction-related costs does not extend to transaction-based payments made to the operator, depositary or custodian, or anyone acting on their behalf; all such amounts must be taken into account in the disclosure figure.

1.6 Under a fee-sharing agreement, the management company or another party may be meeting, in all or in part, costs that should normally be included in the ongoing charges disclosure. They should therefore be taken into account by adding to the total ongoing charges disclosure any remuneration of the management company (or another party) that derives from such fee-sharing agreements. However, there is no need to take into account fee-sharing agreements on expenses that are already accounted for in the ongoing charges disclosure. Thus:

- the remuneration of a management company through a fee-sharing agreement with a broker on transaction costs, or with a custodian on stock-lending income, or with other management companies in the case of a fund of funds, should be taken into account in the disclosure figure;
- conversely, the remuneration of a management company through a fee-sharing agreement with a fund (except for the specific fund of funds case mentioned above) need not be taken into account.

1.7 Where a UCITS invests a substantial proportion of its assets in other UCITS or collective investment undertakings (CIUs), and so makes the disclosures required by Article 55(3)[8] of the UCITS Directive, its ongoing charges figure should take account of the ongoing charges incurred in the underlying CIUs, to the extent that it is possible to do so accurately. [*It is envisaged that CESR may develop guidance on what constitutes a 'substantial proportion' within the meaning of Article 55(3)]* The following should be included in the calculation:

a) if the underlying CIU is a UCITS (or a non-harmonised CIU which elects to comply with the KID disclosure requirements) its most recently available ongoing charges figure should be used; this may be the figure published by the CIU or its operator, or a figure calculated by a reliable third-party source if more up-to-date than the published figure;

b) if the underlying CIU is operated by the UCITS operator or an entity within the same group as the UCITS operator, but does not fall within (a), the UCITS operator should make a best estimate of its ongoing charges following the methodology applicable to UCITS funds;

c) if the underlying CIU is operated by a third party and does not publish an ongoing charges figure, the UCITS operator should use any published information which represents a reasonable substitute for that figure (e.g. a total expense ratio published by a reliable source) or else should make a best estimate of its maximum level based on scrutiny of the CIU's current prospectus and most recently published report and accounts;

d) where CIUs falling within (c) represent less than 15% of the UCITS' assets, it is sufficient to use the published annual management charge for those CIUs instead of estimating their ongoing charges;

[8] Numbering according to the draft recast of the Directive.

e) in all cases, the ongoing charges figure may be reduced to the extent that there is any arrangement for the investing UCITS to receive a rebate or retrocession of charges from the underlying CIU;

f) any subscription and / or redemption fees payable in relation to the underlying CIU should be regarded as transaction charges and need not be taken into account in the calculation of the ongoing charges figure.

1.9 In the case of an umbrella fund, each constituent sub-fund should be treated separately for the purpose of this section, but any charges attributable to the umbrella as a whole should be apportioned among all of the sub-funds on a basis that is fair to all investors.

Part 2 Methodology for calculation (except for new funds)

2.1 The ongoing charges figure should be expressed as the ratio of the total discloseable costs to the average net assets of the UCITS, calculated according to this section. The figure should be expressed as a percentage to two decimal places.

2.2 The ongoing charges figure is calculated at least once a year, on an ex-post basis, generally with reference to the last audited annual accounting period of the UCITS. Where it is considered unsuitable to use the ex-post figure because of a material change (e.g. an increase in management fees), an estimate may be used instead until audited ex-post figures reflecting the material change are available.

2.3 A separate calculation should be performed for each share class, but if the units of two or more classes rank *pari passu*, a single calculation may be performed for them.
[*The section on the use of a representative class will address how the operator should determine which class if any may be selected as representative.]*

2.4 Wherever possible the costs shown should be those set out in the UCITS' statement of operations for the relevant accounting year. They are assessed on an 'all taxes included' basis, which means that the gross value of expenses should be used.

2.5 The average net assets should relate to the same period as the costs, and be calculated using figures based on the UCITS' net assets at each calculation of the NAV (e.g. daily NAVs where this is the normal frequency of calculation approved by the UCITS competent authority).

2.6 Where the ongoing charges attributable to an underlying CIU are to be taken into account:

a) the ongoing charges figure (or equivalent) of each underlying CIU is pro-rated according to the proportion of the UCITS's net asset value which that CIU represents at the relevant date;

b) [either]
all the pro-rated figures are added to the ongoing charges figure of the investing UCITS itself, thus presenting a single total (a 'synthetic' ongoing charges figure)

[or]

some other method of presentation is adopted which shows the ongoing charges of the investing UCITS and the underlying CIUs separately

2.7 Where the competent authority interprets the UCITS Directive as permitting the annual accounting period of a UCITS to be extended beyond 12 months, the competent authority may determine when the calculation should be performed in such cases.

2.8 Information about the ongoing charges figures for previous years / periods should be published at the location (e.g. the operator's website) which is specified in the KID as the general source of further information for investors who require it.

Part 3 Methodology for calculation for new funds

3.1 The same methodology would apply as for an ex-post calculation, subject to the following points:

- figures need not be shown to two decimal places (as proposed in 2.1) if, in the operator's opinion, to do so would suggest a spurious degree of accuracy;

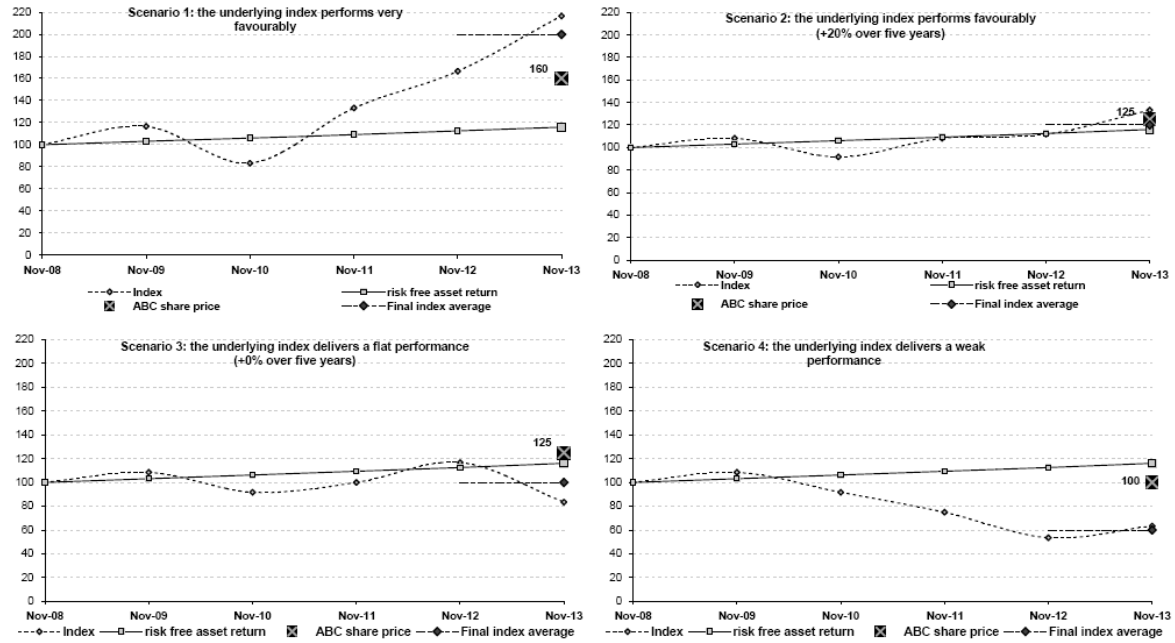
- it should be assumed that no rebates or fee waivers will be received to the benefit of the fund unless these have been disclosed in the prospectus.

3.2 Where an estimated figure is disclosed for a new fund, the operator need not calculate an actual figure on an ex-post basis until 12 months after the date on which units are first offered for sale, or until the end of the first annual accounting period if later. If the actual figure differs materially from the estimate, the KID should be updated accordingly.

Annex C

Performance scenarios – Examples of graph- and table-based approaches

Graph



CESR

Table

Scenarios	Assumptions		Fund share price at maturity date	Performance of the Fund over five years	Explanations
	Final Index level (as "averaged" over the last year)	Index performance over five years			
Scenario 1: The underlying index performs very favourably	12000	+100%	€160	+60%	The 60% per Share is derived from the rise in the Index (100%) multiplied by 60%.
Scenario 2: The underlying index performs favourably	7200	+ 20%	€125	+25%	The return will be €125 which is made up of the Protected Maturity Share Price of €100 per Share and the minimum Index Linked Return of €25 per Share.
Scenario 3: The underlying index delivers a flat performance	6000	0% (flat)	€125	+25%	
Scenario 4: The underlying index delivers a very weak performance	2400	- 60%	€100	0%	As the Index has fallen by more than 50% from the Initial Index Level of 6000, the return will be the Protected Maturity Share Price of €100 per Share.