

Our reference RS09090701
Your reference CESR/09-552
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Subject: CESR's consultation on the format and content of the KID

Please find below the comments of Robeco with regard to the CESR's consultation papers on the format and content of the Key Information Document (CESR/09-552 and CESR /09-716). In our response we first give our remarks with regard to the initial consultation paper CESR 09-552 and its Annexes, followed by our remarks to the Addendum (CESR/09-716). We hope that our remarks will contribute to a further improvement of the final level 2 advice of CESR with regard to the KID.

Section 1-3

p. 10- 16: Rules form and presentation of the KID

We are of the opinion that the suggested rules strike a good balance between a principle based approach and where necessary a rule based approach, in order to achieve that the KID is build up the same way around Europe and recognisable and comparable for investors, whereas leaving enough room for the individual firms to use its corporate branding. We can therefore agree with the proposals in Box 1-3.

Section 4: Objectives and investment policy

p. 18-20, box 4

With regard to this box we have three remarks:

- i) In article 1e of Box 4 the inclusion of performance scenario's or a probability table with regard to structured funds is required, as further worked out in section 14 of the consultation paper . Below, at the comments with regard to section 14, p.67 of the Consultation paper, the arguments are given why **we strongly advise not to require the use of performance scenario's or probability tables as proposed**. Both approaches have severe flaws/ fail to supply the necessary implementing

rules and will therefore give rise to serious problems in implementation or enforcement by the supervisory authorities. Further we are of the opinion that the information is very likely to be misjudged by investors.
 An alternative approach is suggested in our comment below, which is more suitable in our opinion.

The final level 2 advice of CESR should solve most of the methodological issues in this respect. If that is not done, then a repetition of the mistakes/problems with the current Simplified Prospectus is very likely to occur, as a divergent implementation across Europe is likely to happen.

ii) In article 1b iii the words “if applicable” should be inserted before “any minimum rating requirements”.

Section 5: Risk and reward disclosure

p.25

What are your views on the advantages and disadvantages of each option described above?

We disagree with the reported advantage of the enhanced narrative approach that it would enable firms to reflect more accurately the potential complexity of the fund’s risk profile. The main argument is that a narrative can only list the identity of risk sources, without being explicit about:

- the fund’s exposure to these risk sources , and
- the variability of the underlying risk source.

The synthetic indicator embraces risk sources, their variability and the fund’s risk exposures.

We also disagree that an enhanced narrative does not have methodological issues. Should the risk and reward disclosure provide any information that enables meaningful inter-fund comparisons, then the constituents of the narrative should be harmonized and described in great detail. This implies that there should be a blue-print for the narrative’s set-up and textual formulations (supported by a methodology behind it). This is absolutely necessary in order to be able to classify that a certain fund, e.g. has a “high/ medium or low” currency risk.

Without harmonised European rules with regard to the narrative approach, this approach will mean the failure of the Simplified Prospectus will be repeated for this subject. As each producer will then make its own text, it will, from a investors point of view, result in:

- confusion (as they might not understand the text used by some firms);
- misleading (as two firms might use similar risk descriptions for their respective funds where the probability and consequences might be materially different, or the situation of two fund with similar risk profile the fund that uses the most “conservative” wording will look less appealing).

The main and crucial disadvantage of the narrative is already listed: it does not foster easy comparability across funds. Since improved (cross-border) comparability is the foundation on which KID disclosures are built (see p.1 par. 2), this disqualifies the pure narrative approach. In addition, consumer testing supports the synthetic indicator (p.22).

We therefore support CESR’s preferred option of the synthetic indicator.

p.25 :

Do you agree that Option B (a synthetic risk and reward indicator accompanied by a narrative) should be recommended in CESR's final advice? Respondents are invited to take due account of the methodology set out in Annex 1, as supplemented by the addendum to be published by the end of July, when considering their view on this question.

We fully agree that option B (synthetic indicator accompanied by a narrative) should be recommended in CESR's final advice.

With regard to box 5b we suggest that in article 1 the words "not captured in the SRRI" are inserted in the second line after "supplemented by a narrative description of the main risks", as it would be superfluous to also in a narrative way describe the risks already captured in the SRRI. In the explanatory text the last sentence on p.29, continuing on p.30 ("This description enhanced narrative approach), should be deleted.

With regard to Annex 1 we have some specific remarks which are listed below.

p.30 :

Do you agree with the proposals for presentation of risk and reward in Box 5B? In particular, is the proposed methodology in Annex 1 capable of delivering the envisaged benefits of a synthetic indicator?

Yes, we are convinced that a synthetic indicator derived according to the methodology described in Annex 1 is capable of delivering advantages such as transparency, comparability, information content, ease of computation by the industry and ease of monitoring by regulators.

Whereas we agree with the outline methodology, we however have two important specific remarks and comments with regard to Annex 1:

pp.76, 83 :

CESR has abandoned its initial proposal of **7 risk categories** and reduced it to 6. No arguments whatsoever are given for this change. We strongly ask CESR to return to the 7 categories or give a valid explanation for this change. After all, 7 categories offer more discriminatory power than 6 (especially when extending the SRRI in a later stage beyond UCITS funds). Maybe the reduction of risk categories was a first step in an attempt to minimize migrations between categories. However, stability of risk classifications can and should be enforced by formulating proper migrations rules instead of by reducing the number of risk categories. For migration rules see our remarks with regard to the Addendum (CESR/09-716).

p.81, par.48 :

In the historical simulation methodology, the drift of the sampled underlying index returns should be normalized to the risk free rate (this is basically a **risk neutrality** assumption). This normalization prevents past bull or bear markets to influence the current VaR (and hence volatility) estimate. See also our specific comments to the Addendum on this point.

p.31 :

Does the methodology proposed by CESR work for all funds? If not, please provide concrete examples.

Yes. Since for complex funds the volatility for classification is derived from a VaR measure that makes no explicit distributional assumptions (since it is based on historical simulation), complex structured funds and derived dynamic trading strategies (such as CPPI and the like) can be tackled by this methodology.

We would like to stress that there is no real difference between the methodology proposed for structured and complex funds (including guaranteed funds) and the methodology proposed for the remaining fund types.

After all, for the majority of the funds (i.e. “simple funds” using no or little non-linear derivatives), VaR could be estimated directly from the historical volatility of the fund. Hence, for these funds there is a one-to-one relation between the normal VaR and the historical volatility.

For structured funds, including guaranteed funds, the return distribution can be markedly asymmetrical and hence non-normal. For these funds, the VaR can be estimated using the current portfolio composition of the fund and the actual returns of the portfolio components over some historical period (the so-called “historical simulation VaR”).

So for the majority of funds, VaR and volatility are synonymous, whereas for structured and guaranteed funds the VaR is the preferred risk metric (and a better gauge for downside risk than historical volatility derived from a “replicating portfolio / delta-representation” approach).

p.31 :

Respondents are invited to take account of the methodology set out in Annex 1, as supplemented by the addendum to be published by the end of July, when considering their view on the questions above.

See our comments above.

p.31 :

Are there any other issues that CESR should consider if it decides to recommend this approach to the disclosure of risk and reward?

Yes :

- Unambiguous fund typology so it is clear what methodology should be applied for what fund.
- Clarity of exposition of the methodology in unambiguous steps, leading from data (or proxy data) to the VaR and the derived volatility.

Section 6: Charges disclosure

p. 34: Do you agree with the proposals in Box 6, in particular with the prescribed format for the charges table.

We can agree with box 6. Further we are of the opinion that it is necessary to have a prescribed format for the charges table for reasons of comparability for the investor as well as for reasons of creating a level playing field between different fund producers.

p. 35/36 Summary measure of charges (box 7)

With regard to the summary illustration of charges we are of the opinion that CESR should prescribe the specific growth rates to be used. Without prescribing the specific growth rates there will be no

level playing field for fund producers and the consumer end up with figures he can't and shouldn't compare and is therefore possibly easily misled. If prescription of specific growth rates is not feasible then the proposal inclusion of a summary measure should be skipped in the KID. The otherwise required and presented information on charges that is available in the KID is then to be seen as sufficient.

p. 36-39, box 8-10

We can agree with the proposals in box 8-10, with the exception that only changes in charges that the management company has influence on, should have to be taken into account for the assessment of a material change during the year (box 9)

Section 7: Past performance

p.40-49, box 11-16

We can agree with the proposals in box 11-16.

Section 8: Practical information

p. 49/50, box 17: Content of the practical information

The second article of this box ("statement on liability") could in our view be deleted as the added value can be questioned. It is in our view a superfluous sentence of which we have serious doubts if investors read it, need it or would recall it after they have read it.

In the third article of box 17 it is stated that any change in the section "Practical Information" shall be regarded as material and therefore require a prompt revision of the KID. We question this need for prompt revision as some of the information is in our opinion not "vital" for the investor. Example of this is the name of the depositary.

p. 51, box 18

We can agree with the proposals in box 18 on the use of signposting

Section 9 Circumstances in which a KID should be revised

p.53/53, box 19

Do you agree with the proposals for the circumstances in which a KID should be revised?

We are of the opinion that the rules for revision of the KID should be simplified and be less extensive. Review of the KID is required at too many occasions during the year.

We suggest the following rules:

- Annually at the beginning of each calendar year the KID has to be updated (because of the update of at least the performance figures) within .. working days.
- Revision during the year when there is a material change in the content of the KID.

Further rules are in our opinion not necessary.

Section 10-13, umbrella funds , share classes, fund of funds and feeder funds

We have no remarks with regard to these sections, with the exception of box 22, first article. We are of the opinion that a description of the selection process of funds of funds is something that is quite difficult to describe, especially in a short and meaningful way for investors. We therefore suggest deleting this item for the KID.

Section 14: Structured funds, capital protected funds and other comparable ucits

p.67 :

Do you agree with the above CESR proposals on performance scenarios? In particular which option (A or B) should be recommended? If not, please suggest alternatives.

We neither agree with prospective performance scenarios nor with probability tables. Our basic argument is that additional information is required to inform investors how a complex product works. This could be accomplished by purely illustrative scenarios. However in order to prevent that the investor attaches some degree of realism to the illustrative scenarios, the regulators should clearly prescribe (at level 2) what the illustrative scenarios should look like.

We first outline our problems with the proposed methods and then sketch our suggested alternative.

> Problems with prospective scenarios

On pp.63-64 it is stated that performance scenarios or performance tables should be placed in the context of giving the investor a better understanding of how the product works. This is a "what-if" analysis.

However, the text mentions "prospective scenarios" and it is unclear what "prospective" should mean: is it a likely future scenario? But this interpretation is much wider (in fact too wide) given the objective of explaining the working of a product to investors.

On p. 65 it reads that : "They [prospective scenarios] 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." However, a what-if analysis does not attach any probability to the "if" so a scenario analysis can at best provide information about some risk *exposure* of a fund.

In addition, it is not clear how "extreme scenarios" could and should be selected. An ultimately extreme "worst case scenario" is certainly not appropriate, but it is unclear what criteria a less extreme "worse case scenario" should satisfy.

On p.65 it is remarked that "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." However, the crucial questions are (1) how scenarios should be selected (given the wide range of assets underlying complex / structured products), (2) how reality checks can be performed, and (3) what their information content is.

It also reads that "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 at Level 3 in order to foster a more harmonised approach to selection of the scenarios." This shifts the basic problem with performance scenarios to level 3. The problem of scenario formulation can only be tackled when :

- the scenarios are purely illustrative,
- they illustrate the working of a complex product (based on prescribed scenarios), and
- are not meant to contain any prospective component or risk level.

> Problems with probability tables (Annex 4)

The text raises many questions. The underlying methodology is clearly Monte Carlo simulation, but:

- what models and versions of models are allowed?
- how should stochastic processes governing the evolution of the underlying variables be defined, and
- over what period and with what data should the parameters be calibrated and re-calibrated ?

In addition, the focus is again prospective: not illustrating how the fund works or would have fared in the past, but providing ex-ante risk-reward information that crucially depends on underlying assumptions, simulation and pricing models, and parameter inputs.

> Suggested alternative: illustrative example

This alternative proposal involves an **illustrative simple example** showing how the product works. On the basis of specified scenario's (at level 2) this illustration should be formulated clearly and unambiguously in terms of "suppose the underlying index reached value X, then the return / payoff of the fund will be Y" etc.

Remarks with regard to the Addendum to CESR's consultation paper on the format and content of Key Information Document (CESR/09-716)

Question 1. Do you agree with the criteria considered by CESR to formulate its proposals regarding the volatility intervals? Are you aware of any other factors that should be considered?

One criterion should be added: the risk classification on the basis of the SRRI should be **sufficiently discriminatory**, i.e. the investor should be able to distinguish between different funds on the basis of the SRRI.

Since the objective of the SRRI is to enhance the (cross-border) comparability of UCITS funds for investors, the classification of funds along the risk buckets – and hence the definition of the limits separating these buckets – should provide sufficient discriminatory power and avoid crowding of funds in only one or a few buckets.

This implies that the volatility buckets shouldn't be too wide in order to avoid crowding in only a few buckets (for example almost all equity funds in 5, almost all bond funds in 4, etc.).

Question 2. Which option (A or B) do you see as more appropriate for the KID?

Instead of focusing solely on the frequency of migrations, the objective of the risk classification should be to offer investors the information required to make a judicious choice between UCITS funds on the available risk spectrum. This implies that the differences in risk levels of the buckets should not be too large, otherwise crowding will occur and discriminatory power will be lost.

For this reason (see under question 1), we prefer option B, at least allowing some distinction between the 10% and 25% volatility levels. In this context, we object to the fact that CESR has abandoned the initial proposal of **7 buckets**.

Since:

- there are other ways to mitigate migrations (see under Q4), and
- 7 categories offer more discriminatory power than 6 (especially when extending the SRRI in a later stage beyond UCITS funds)

we would suggest the reinstallation of 7 risk buckets. The frequency of undesirable migrations can be tackled with proper migration rules. See our further remarks below.

Question 3. Would you like to propose any other alternative for the volatility intervals? If so, please explain your reasoning.

For the sake of discriminatory power, to help the investor as good as possible to distinguish between alternative funds, we propose a 7-category scale:

category	limits	
	lower	upper
1	0	2.5
2	2.5	5
3	5	10
4	10	15
5	15	20
6	20	30
7	30	inf

It's a matter of taste whether the second category starts at 2.5% or 1.5%, though. Restoring the number of intervals to the original 7 allows for offering an additional breakpoint at 20% volatility. At the same time it allows accommodating extremely risky funds (especially when the application of the KID is extended to non-UCITS).

In order to avoid crowding, the higher risk buckets should not be too wide. In order to provide distinctive differentiation between risk levels, the lower risk buckets should not be too narrow.

Migration issues can further be tackled separately with proper migration rules.

Question 4. Do you agree that introducing some rules for assessing migration is desirable?

Yes, definitely. See above.

Question 5. If so, which option (2 or 3) do you think is more appropriate?

We deem **option 3** most desirable. Using different thresholds to define a “buffer zone” around the volatility limits is an easy, intuitive, pragmatic and effective way to control migrations. On the one hand, the oscillation of funds around risk limits is undesirable since this will result in frequent switches that most likely are not driven by significant changes in the funds' risk levels. On the other hand, when a fund's risk profile changes markedly this should be reflected in a migration. Defining a

buffer zone on the basis of the volatilities' standard errors is consistent with acknowledging the presence of estimation errors. It allows for mitigating "phantom migrations" that arise because of pure chance.

Option 2 proposes to mitigate the frequency of "phantom migrations" by making the risk classification "sticky", thus requiring a fund to reveal a higher or lower bucket volatility level for a prolonged time (of say 3 months). We list the following disadvantages:

- this procedure requires more frequent risk calculations
- problems with oscillating funds (i.e. funds with estimated risk levels very close to a bucket limit) may continue to exist
- when shifting the volatility estimation window 13 weeks (3 months) back, this will still keep an overlap of 143 weeks in the most recent and 3-month past windows; the relatively small number of different observations will have only a limited effect on the volatility estimate
- the period of 3 months is arbitrary (as is any other period).

We note that it is a pity that no empirical work is done on a longer time frame (longer than the 3 years in the Consob study) to study :

- the frequency of migrations under varying conditions of market dynamics
- the efficacy of migration rules.

Nevertheless, we are convinced that the migration rules under option 3 can mitigate unwanted migrations.

Question 6. Would you like to propose any other rule for assessing migrations? If so please explain your reasoning.

No. Option 3 is adequate. It could be felt as more comforting to widen the buffer zone around the category limits from ± 1 standard error to ± 2 standard errors.

Additional comment on p.11, section 3.2.2. Total return funds :

The Addendum classifies CPPI products or strategies and their varieties as total return funds. Compared to market practice, that is surprising. In addition, these types of funds do not have a pro-forma asset mix that is consistent with and representative of the investment policy of the fund. Hence, the number sub b cannot be computed.

In the original proposal, these funds (dynamic trading strategies focusing at mitigating risk, conditionally or unconditionally) are classified as complex/structured products. In effect, their formula-based trading strategy allows for estimating these funds' VaR, which can next be translated in terms of volatility.

Furthermore, the Addendum now signifies structured products by definition as finite-maturity. This re-definition of structured funds expelled dynamic trading strategies such as CPPI to another fund category, thereby basically moving the problem to another place.

We propose adhering to the original fund classification (as in CESR/09-552) and distinguish between finite-maturity and infinite-maturity funds in the structured funds category.

Question 7. Do you agree with CESR's proposal concerning the methodology to compute the SRRI of structured funds? If not, please explain and, if possible, suggest alternatives.

We agree with:

- the use of VaR for structured funds
- taking the maximum of (annualized) 1-year VaR and annualized VaR at maturity date.

However, between steps 1 and 2 in Box 3 and Box 4, describing the historical simulation method, the requirement should be added **to adjust the drift of the set of sampled underlying index returns equal to the risk free rate**. This implies subtracting the arithmetic mean of the sampled returns and adding the risk free rate. In this way, the **risk neutrality assumption** used in reverse engineering the volatility from the estimated VaR is also imposed on the historical simulation of the underlying index from which the VaR is estimated. This is consistent with the reverse engineering of volatility as described on p.11 of the Addendum as well as on p.80 paragraph 37 of the Consultation Paper (CESR/09-552). When risk neutrality is not used in the historical simulation, the estimated VaR depends on whether the past 5 years can be characterized as mainly bull (under-estimating risk) or bear (over-estimating risk). Rescaling the mean sampled return to the risk free rate solves this (potential) problem and retains consistency with the Consultation Paper.

Surprisingly, the risk-neutrality assumption is proposed and discussed intensively in **Annex 4** of the Consultation paper CESR/09-552, pp.90-91. We quote :

"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.

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."

We support these arguments and claim that they also hold for the historical simulation VaR methodology.

In addition, the precise methodology should be described clearly in great detail in order to prevent ambiguities. For example, using a window of 52 weeks over a period of 5 years will yield 208 annual returns, not 260. And shifting the mean of the historically sampled underlying index return distribution to the risk free rate corrects for any bias that may occur from bull or bear markets over the past 5 years. Finally, from the two boxes it appears as if the fund return follows a normal distribution (!), whereas the actual returns on the underlying index are sampled and next the fund returns conditional the sample return path of this index are calculated.

Given this historical simulation methodology, the rule-based VaR is easy to monitor by regulators (just as the historical volatility).

Question 8. Do you agree with CESR's proposal to use VaR as an (intermediate) instrument for the measurement of volatility? Is the proposed VaR-based approach appropriate to convey correct information about the relevant return volatility of structured funds?

Yes, we agree. Historical simulation 95%-VaR takes into account distributional asymmetries and downside risk. When converted to volatility using the normal distribution assumption, the derived volatility applies to the actual 5% loss quantile of the fund's return distribution. Hence, the derived volatility level is relevant when characterizing the potential risks of loss for structured funds. (Note that for market funds, their volatilities apply to all the quantiles of their return distributions.)

Question 9. Do you share the view that the solution proposed by CESR is flexible enough to accommodate the specific features of all (or most) types of structured fund? If not, please explain your comments and suggest alternatives or explain how the approach could be adjusted or improved.

Yes, when the historical simulation VaR method is described in an unambiguous and clear way (leaving no room for misinterpretation or framing) it signifies a **market practice** approach to estimating risk in case of distributional asymmetries or irregularities. When one knows how a structured product works, one can construct its return series conditional on its underlying index (or indexes) and construct the distribution of its returns.

Question 10. Do you agree with CESR's proposal concerning the methodology to compute the VaR-based volatility of structured funds over a holding period of 1 year? If not, please explain your comments and suggest alternatives.

We agree, conditional on some pending issues that we outlined in our answer to Q7.

Question 11. Do you agree with CESR's proposal concerning the methodology to compute the VaR-based volatility of structured funds at maturity? If not, please explain your comments and suggest alternatives.

We agree, conditional on some pending issues that we outlined in our answer to Q7.

Question 12. Do you agree with CESR's decision not to promote further the adoption of the delta representation approach for the computation of volatility of structured funds?

Yes, we agree. The historical simulation VaR is a superior way to gauge a structured fund's risk level. The disadvantage of the delta approach is that it does not (and cannot) take into account the changing portfolio mix over the course of the year (as a function of the dynamics of the underlying reference index).

Question 13. Do you share the view that CESR's current proposal represents an improvement with respect to the delta representation approach? If not, please clarify why you believe that the delta representation approach may be more suitable to estimate the volatility of structured funds.

Yes, the historical simulation VaR represents a significant improvement over the delta approach.

Question 14. Do you consider it possible and appropriate to allow the use of Monte Carlo simulations for the computation of the SRRI of structured funds? If yes, please explain whether these methods are more suitable for the computation of VaR or, directly, for that of volatility measures.

We deem it neither possible nor appropriate to allow for the use of Monte Carlo simulation. Historical simulation uses the actual "realized" return distribution (whose mean should be corrected, though). Monte Carlo simulation needs as inputs distributional assumptions (normality, e.g.) and parameter estimates for this distribution. Monte Carlo simulation only yields acceptable results when these inputs are estimated in a proper way: from actual time series. But when actual time series are available, the need for MC simulation disappears. When no actual return series are available, neither historical simulation nor MC simulation will work.

Question 15. Do you believe that it would be possible to avoid significant differences in the outcome of such simulations across management companies? What should be the key methodological requirements needed to avoid such divergences?

We believe that it is possible to outline the historical simulation VaR methodology in such a way that ambiguities and misconceptions are minimized. The description of the calculation steps should be concise and clear, and an illustrative example should be included. In this way, the methodology is easy to monitor by regulators and facilitates the uniform compliance by asset managers.

Final remarks

Robeco is of the opinion that the creation of the KID will mean a real enhancement in the transparency towards investors. Especially as it is build on harmonised European rules, it will also enable the consumers to more easily compare investment funds. Also for industry such harmonised rules are vital, as it enhances the level playing field for producers.

Yours sincerely,
Robeco

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