European Fund and Asset Management Association

EFAMA REPLY TO CESR'S CONSULTATION PAPER ON TECHNICAL ISSUES RELATING TO KEY INVESTOR INFORMATION DOCUMENT (KID) DISCLOSURES FOR UCITS

EFAMA is grateful for the opportunity to comment on CESR's Consultation Paper. We highly welcome the work of CESR's Drafting Groups on technical issues, and thank CESR in particular for including industry experts. However, given the complexity and the high technical level of some of the topics, EFAMA would have appreciated if CESR had publicly consulted stakeholders an earlier stage.

RISK AND REWARD DISCLOSURE

Option A – Enhanced narrative approach

EFAMA acknowledges CESR's decision not to consult on Option A (enhanced narrative approach) in this Consultation Paper. Nonetheless, we would like to summarize once more the investment management industry's position regarding the use of narrative vis-à-vis a synthetic risk indicator.

While a synthetic and visual representation of risk could be more appealing to investors, a risk indicator alone cannot cover adequately all risks related to the fund (and in particular risks such as liquidity, counterparty risk), regardless of the methodology employed. The fact that disclaimers should deal with as many as 9 issues according to CESR (Para. 1.2.10) is also proof of the limitations of the SRRI.

Narrative is the preferred approach for the majority of investment managers. However, should the decision be taken that a synthetic risk indicator is to be included in the KID, a large majority of EFAMA members believe it is essential that the indicator be complemented by further narrative description of the fund's risks.

We already urged the consumer testing of such a combined approach in our reply to CESR in December 2007. Most of our members do not find the disclaimers provided by CESR in this Consultation Paper sufficient to qualify as a "combined approach". More space should be made available for narrative description of risks (for example main risks for the fund, risks possibly not covered by the indicator, etc.), enhancing investor understanding and reducing possible liability for the industry.

EFAMA remains ready to provide assistance to CESR regarding narrative text to be used in consumer testing.

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Option B – Synthetic risk and reward indicator

From past and ongoing discussions, it is clear that all methodologies have pros and cons, and a choice always involves some tradeoffs between accuracy and simplicity/ease of use. Three aspects are, however, crucial for EFAMA members: to ensure that the methodology chosen is robust and not misleading for investors, that the methodology can be implemented without additional high investments, and that the calculation must be standardized, thus allowing for fair comparisons among funds.

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?

Volatility
Many EFAMA members agree with CESR that historical volatility is the most appropriate methodology, and that it would lead to a comprehensive and easy to implement approach to risk/reward presentation. In their opinion, the indicator should be kept simple and robust, and easy to implement and monitor. The time series chosen are deemed to be appropriate[1], as well as the proposed fund categories. The methodology would also appropriately discriminate between different funds.

For some EFAMA members, past performance cannot be considered as a reliable guide to future performance and risk, but they nonetheless prefer volatility to other methodologies, and acknowledge that it does meet several criteria.

A few EFAMA members favor the use of volatility but with modifications in the calculation, or with the addition of other metrics.

VaR
A significant part of our members however, disagree with CESR's proposal and find that VaR is generally preferable to volatility. They believe that volatility is inappropriate to capture risks for all fund categories, although it could be somewhat acceptable for "simple funds" such as monetary funds, funds invested in bonds in a constant proportion, and funds invested in equities in a constant proportion, to the extent that such funds can be seen as providing a log-normal distribution of return. For such funds, historical volatility could be used to arrive at VaR values. The risk

[1] One of our members expressed a preference for a time series of 5 years, as it would be more relevant.

categorization for other funds, including funds with any degree of exposure to alternative strategies and use of derivatives, would be calculated on the basis of VaR. For more details, please see Annex I.

In any case, EFAMA members believe that also the use of VaR should be standardized and the calculations carried out on the basis of predetermined factors, according to fund categories.

Although VaR is deemed to be more accurate by some EFAMA members, concerns about its implementation costs were voiced by other investment managers. With regard to ex-ante VaR, the lack of standardization in calculation was mentioned as a further drawback.

A few EFAMA members endorse other methodologies such as expected loss, downside deviation, qualitative methodologies, or the use of asset class data instead of fund data for categorization.

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?

EFAMA members supporting volatility mostly agree with the use of the add-on as proposed, at the option of the investment manager.

With the use of VaR, a large part of EFAMA members believes that the use of the risk "add-on" would be unnecessary. The same would apply in case asset classes were used.

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?

EFAMA members favoring the use of volatility deem the proposed fund categories to be appropriate, and the methodology as capable of covering all of them.

However, it might be appropriate to continue studying other options, but only specifically for complex/structured funds and guaranteed funds. For example, historical simulation VaR with fund backtesting, can tackle the specific risk profiles of these funds; for the other funds, the equivalence between volatility and normal VaR can be retained.

EFAMA members in favor of VaR, instead, would distinguish between “simple funds” (with log-normal distribution - see our answer to Q 1-3), complex funds and structured funds, with volatility possibly used for “simple funds” to calculate VaR, which alone would be suitable to cover the other fund categories.

With regard to the add-on and the exclamation mark modifier, please see our answer to questions 9-11.

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?

EFAMA members supporting volatility mostly agree with the use of the add-on as proposed, at the option of the investment manager. However, some of them are concerned it could be misinterpreted by investors or it would limit comparability, and would replace it with a narrative disclaimer. Some also believe it should not be used for new funds when historical data is not available or is insufficient.

However, EFAMA members supporting volatility disagree with CESR’s proposal interpretation of category 7, which is defined in Para. 77 as a category “designed to cover those products (typically structured) the risk profile of which is not suited to a volatility-based methodology.” Category 7 should be considered simply the highest risk category, without any special meaning or function (and therefore without any negative connotation). This would be in line with the original proposal by industry experts in the Drafting Group. There should be no systematic assignment of structured/guaranteed funds to Category 7.

For proponents of other methodologies (VaR included), the use of add-ons, modifiers and Category 7 as proposed by CESR would not be necessary.

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?

Volatility is considered very easy to implement by EFAMA members, and not requiring new investment. Some of our members have expressed the desire to maintain volatility as the methodology for non-sophisticated funds.

Although considered superior as a methodology by many EFAMA members, there are concerns among some about the costs of VaR implementation for all funds, a factor that CESR should carefully consider.

For VaR, standardization of parameters would be required as well, to ensure comparability of categorization.

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

The great majority of EFAMA members agree with CESR's proposal of 7 categories on a scale.

Some, however, believe that the number of categories should be even, so that investors could not automatically choose the "middle option". This is particularly important as the proposal is to use a non-linear scale and the middle category would therefore not equate with "medium" risk.

Others are of the opinion that 7 categories are too many and would confuse investors, while fewer categories would enhance consumer protection.

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?

Some EFAMA members agree that the scale should be non-linear, as the potential change in volatility is related to the level of volatility. A scale which is coarser for low volatility and more refined for higher volatility levels might be most suitable, as it would ensure a fair distribution of funds along the scale (lower probability of clustering), and enhance the stability of fund classification over time. The risk buckets should be defined by volatility or VaR limits (depending on the calculation methodology), as the most objective way to classify funds and ensure comparability of rankings.

It is recognized that – although a non-linear scale is appropriate – its representation might not clearly reflect the relative risk of various funds. To avoid misunderstandings by investors, solutions could be found such as an explanatory text warnings or a modification in the size of the boxes to reflect the differences.

However, some EFAMA members do not agree with CESR's proposal to use a non-linear scale, as it would be too difficult to understand or misleading for investors. A linear scale is considered more appropriate.

Annex I presents a proposal for a scale linked to the use of VaR.

Guaranteed funds
The great majority of EFAMA members agree that the KID for guaranteed funds should have a synthetic risk indicator showing the risk/reward category when the guarantee does not apply. For example, if the guarantee does not apply between issuance and maturity, the fund would be categorized according to the chosen methodology, but the text accompanying the SRRI would clearly describe the existence of the guarantee, its characteristics, and the fact the guarantee would apply at maturity, providing a balanced presentation of risk and reward.

It should be ensured that the risks and rewards of guaranteed funds are correctly presented to investors, but also that such products are not penalized vis-à-vis non-guaranteed funds (thus appearing riskier) and, in particular, vis-à-vis other structured products which could be sold without risk indicator and where the “safety” component of the guarantee could be overemphasized.

The introduction of the SRRI must not have the unintended consequence of favoring investment in products that provide less transparency and investor protection due to a different legal wrapper.

Due to these concerns, some EFAMA members suggest instead to categorize guaranteed funds automatically in category 1 (the lowest one) or to create a separate category "0”, reflecting the existence of the full guarantee on the invested capital. In that case, the text describing the guarantee could be moved to the KID section on “Investment strategy and objectives”.

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

Yes, EFAMA agrees that no other description should be used. Some of our members, however, do not believe that the exclamation mark modifier should be used, either because it is considered likely to be confusing for investors, or because it would be superfluous (when VaR is used). See our answer to Questions 9-11.

18) Do you agree that some funds belong in category 7 due to their special characteristics (see above explanations)?

Regarding the funds that belong in Category 7, we disagree. Please see our reply to Questions 9-11.

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?

We broadly agree with the form of the modifier (exclamation mark), but please see our answer to Question 17.

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?

A majority of EFAMA members have the following comments:

1. The first disclaimer should be modified in line with MiFID wording: "historical data is not ***a reliable*** indication of the future".
2. There is no need to explain the meaning of the lowest and of the highest categories of risk, as the words and the arrows above the scale already convey the same concept, in a more effective visual form.
3. The disclaimer with the reason why the fund is in a certain category should be deleted, and replaced with a longer narrative description of the fund risks (main risks, risks not covered by the indicator, etc.). Please see our comment above about a combined approach.
4. There should be a signpost/reference to the prospectus or other explanatory material for more information on the risk indicator and a detailed description of fund risks.
5. Regarding the guarantee or protection, most details should be included in the Investment objectives and Strategy section.
6. The warning regarding the suitability for investors wishing to redeem within a certain period should be deleted, as it might mislead investors into thinking that holding the fund for the minimum holding period would necessarily lead to a positive return. Furthermore, a generalization about the holding period without regard to market conditions or investor's needs and objectives might not be possible or lead to incorrect advice.

Few EFAMA members agree with all disclaimers proposed by CESR.

Some EFAMA members suggest the following addition to the SRRI: "The calculation of the above indicator is based on data from [date]", as the data shall be older than the date of publication of the KID, especially in case of translation into other languages.

We encourage CESR to continue the discussion with stakeholders on methodological aspects of the Synthetic Risk and Reward Indicator (SRRI) and of Performance Scenarios, as many issues need to be further refined and improved.

PAST PERFORMANCE

First of all, EFAMA wishes to stress the importance of a harmonized methodology for calculation and presentation of past performance, to provide comparability among funds across the EU.

Secondly, we believe that past performance and performance scenarios should not be confused, as performance scenarios have nothing to do with the past but rather show the likelihood of future outcomes.

Past performance could be shown also for structured and guaranteed funds if they are still marketed after launch, together with text appropriately describing the effects of the guarantee.

Please see our detailed replies to section 2.2. below regarding performance scenarios.

We do not understand CESR's reference at the top of page 28 to an "***average*** yearly (net) performance", and would like CESR to clarify its meaning.

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?

EFAMA agrees with CESR's proposals regarding bar chart presentation, and finds them easy to implement, but we reiterate our prior comments that the presentation of empty slots when fund performance is not available for certain years must not cause misunderstandings for investors, and specifically must not be misread as zero performance. Solutions to this likely problem must be carefully tested during Phase II of consumer testing.

Some EFAMA members support the addition to the bar chart with yearly performance data also of cumulative performance over longer periods, e.g. 3, 5, or 10 years.

EFAMA is very concerned about the prohibition to show fund performance in the KID unless at least one full calendar year of data is available. First of all, there are liability concerns for the industry: it is possible that civil law would allow claims against fund promoters for deceiving investors by withholding crucial information, if no performance is shown. Should the Commission follow CESR's advice, Level 2 legislation should clearly mention the prohibition.

However, EFAMA believes that once the fund has been in existence for over 12 months, it should be possible to show all past performance since inception (although the first year would not be a complete 12-month period). In other words, after the end of the second calendar year after the fund's launch both the performance for the first (partial) year and for the second (full) year would be shown on the KID. A reference could be made to the prospectus or a website, providing the details of the performance and the fund's date of inception.

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?

EFAMA agrees with CESR's proposed framework, but emphasizes again the need for harmonization of the methodology.

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?

EFAMA members favor a harmonized approach in case of material changes, and they therefore encourage CESR to work on guidance at Level 3 regarding material changes, in order to ensure comparability. Most of them would prefer an EU-wide approach, while others could accept a national approach.

According to some EFAMA member, GIPS (Global Investment Performance Standards) already include rules on material changes, and CESR could adopt such guidelines.

Most EFAMA members favor the adoption of Good Practice 1, while some would either favor the adoption of both, leaving the choice between them to the investment manager, or the adoption of Good Practice 2.

Some of our members believe that the exact date of the material change should be shown on the chart, as well as the nature of the material change.

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?

EFAMA agrees with CESR that a benchmark must be shown on the KID past performance chart only when it is mentioned in the fund's objectives and strategies.

Some of our members, however, believe that it should be possible to show a benchmark at the investment manager's option in other cases.

We believe that the choice of benchmarks cannot be harmonized. In the opinion of most EFAMA members it should be left to the discretion of investment managers. However, the choice of benchmarks should be fair.

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?

A majority of EFAMA members agree with CESR's recommendation, while others believe that a benchmark should be allowed as a proxy for non-existent performance data, as it would not be misleading for investors.

The inclusion of a benchmark could be allowed on condition for example that a specialized auditing firm review such use.

Lack of inclusion of the benchmark in past performance charts would have no impact on the risk and reward profile of the fund, as it would only clearly show to investors that the fund is new, without any negative implications.

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?

EFAMA supports harmonization at EU level for rules regarding track record extension, for investor protection and to maintain a level playing field amongst UCITS.

We are of the opinion that CESR has identified the majority of situations warranting track record extension. However, track record extension could also be allowed when the fund is an exact copy/a clone of an existing fund (although there is no master-feeder relationship): this could happen for example when the fund was already in existence for institutional investors and now it is also offered to retail investors.

EFAMA agrees with CESR's approach to track extension for new share classes.

Regarding master-feeder proposals in Para. 41, most EFAMA members favor option 1. One of our members suggests that the extension should be linked to the feeder accepting strict rules about its composition, that is its investment in the master and in other instruments, while others prefer option 2 but would wish more guidance on the "materiality" of the difference.

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.

EFAMA agrees with CESR's approach that track record extension should be allowed when a fund changes its legal status in the same Member State, but such possibility should also be extended to cases when a fund's domicile is transferred from one Member State to another.

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?

EFAMA agrees with CESR’s recommendation (option c).

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

CESR and the Commission should clarify the purpose of performance scenarios. It is puzzling what role **prospective** scenarios could have in the context of **historical** performance. EFAMA strongly believes that past performance and performance scenarios are totally unrelated and should be treated as such.

If, on the contrary, such scenarios are intended to provide information on risks (Para. 56: “[p]rospective 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.”), then they would belong in the Risk and reward disclosure section of the KID, not in the past performance section. The use of performance scenarios could then be made redundant by the use of a risk/reward indicator. Either the use of volatility or VaR would allow the construction of an SRRI, even for new funds. This would also ensure the comparability of all fund categories, which would not be given by the performance scenarios.

Performance scenarios convey to investors potential future outcomes requiring numerous assumptions that make them difficult to implement:
1) how scenarios should be selected (given the wide range of assets underlying complex / structured products),
2) how reality checks can be performed.

Many EFAMA members reject the use of performance scenarios because they are highly likely to give investors a false sense of security and be interpreted as guaranteeing certain results.

Even if the performance scenarios were retained, they should be moved to the section on Investment objectives and strategy of the prospectus, where they would serve a purely explicatory function. A signpost in the KID would point to more in-depth information and to the scenarios. In fact, investors would be mislead into comparing funds on the basis of the scenarios in the KID, although this is not possible due to the many assumptions required and the fact they cannot be standardized. Such use would actually hurt the comparability of funds through the KID.

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?

Some of our members disagree with CESR’s decision not to allow the use of back-testing, which they believe can prove reliable if it is properly monitored by regulators.

Others also think that it is premature to abandon it, especially considering the significant drawbacks of the other two approaches.

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?

EFAMA disagrees that Option B is capable of meeting the Directive requirement for performance scenarios.

The graph is ambiguous. For example, the path of the underlying is shown, but (1) who decides what path the underlying should follow until the maturity of the product? and (2) for non-path dependent products (payoff only determined by final value of underlying), the intermediate path is irrelevant and may confuse the investor.
The table is in that respect clearer and also more concise. However, the fundamental question remains on what scenarios the table information should be based.

Without any explanatory text, scenarios are likely to be considered as "real" prospective scenarios by investors.

In order to allow for comparability, there should be detailed guidelines on the specification / selection of scenarios. It is fair to require that comparable funds should be subjected to the same set of assumptions, but it is not clear at all how this could be achieved.

Option C: Performance scenarios based on probability tables

EFAMA strongly disagrees with option C, which is the most likely to be misinterpreted by prospective investors as a promise or guarantee of future performance.

1. **Option C is based on a methodological flaw: a confusion between real probabilities and risk neutral probabilities**

Risk neutral stochastic models are models that are used in order to price options. As option theory shows, they are appropriate models to price options, but these risk neutral models are completely inappropriate to give a view of expected returns on any asset.

This is a very classical paradox in option pricing theory. See for example John Hull[2], chapters 10.1 and 10.2 on one-step binomial models and risk-neutral valuation:
"*The option-pricing formula in equation (…) does not involve the probabilities of the stock price moving up or down. (…) This is surprising and counterintuitive (…).*
In a risk-neutral world all individuals are indifferent to risk. In such a world investors require no compensation for risk, and the expected return on all securities is the risk-free interest rate." (…)
This result is an example of an important general principle in option pricing known as "risk-neutral valuation". <u>This principle states that we can assume the world is risk neutral when pricing an option</u>. The price we obtain is correct not just in a risk-neutral world but in the real world as well.

So the risk-neutral model is a model that is efficient to price option, even if the real world is not risk-neutral.

However, the KID is supposed to give the investor an idea of the real world risk-return profile, and for this purpose the risk-neutral world is completely inappropriate. In other words, when pricing an option, we assume that the world is risk-neutral, because this corresponds to the reality of options hedging. However, this does not mean at all that the real world is risk-neutral. The risk-neutral world is a theoretical world that is there only to provide an accurate and tractable pricing framework.

Pretending that the real world is indeed risk neutral is a sort of ideological extension of the model which has nothing to do with what the model says, and is actually contrary to common sense and basic market observations. It is obvious to anybody that the real world includes risks, and the expected return on any asset has some relation to its risks.

2 The use of risk-neutral probabilities would lead to misleading results

A simple example of how the risk neutral world is inappropriate is to apply this approach to all sorts of assets.

In a risk neutral world, the average return of a very simple equity fund investing 100% of its assets in an equity index, for example, would be the risk free rate of return minus the fees and expenses.

[2] John C. Hull: Options, Futures and other Derivatives, Prentice Hall, fifth edition

Indeed, any fund invested in any type of assets would produce the same average return: the risk free rate minus the costs. The expected return of any fund would be equal to the expected return of cash, minus the costs.

By definition, no real risk is taken into account. But what is the purpose of, for example, investing in equities if the average return is the same as the return on risk free assets? What about the equity premium, which is supported by a lot of academic research? The obvious conclusion of a risk neutral approach is that investors should invest only in risk-free assets, which have a better expected return, with less cost and no risk.

3 The only probabilities that make sense for investors are real probabilities, not risk-neutral probabilities

The problem for real probabilities is their evaluation. There are only two ways to evaluate real probabilities:

Risk Premium
Theoretically, probabilities can be inferred from risk premium. For example, we can infer from equity risk premium the real probabilities that are priced by the market for equities. The problem is that there is no consensus on how to calculate them.

Historical Probabilities
Using historical probabilities is the only objective way of calculating real probabilities. We therefore go back to Option A, since back-tests are the appropriate way to compute probabilities based on historical performances.

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

As shown above (see our paragraphs 6.1 to 6.4), they are not appropriate. They rely on a risk-neutral world that does not exist. They misprice the risks.

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

Yes, but see our reply to question 57.

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

No, that would not be easy, because regulators would have to decide on:

- models used;
- more importantly, which parameters are used as Greeks for the simulations: volatility, correlations etc. This may be very arbitrary in practice since those parameters do not have public prices.

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

If such methodology were to be used only for Structured Funds, there would be no comparability with other types of funds.

CHARGES

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?

EFAMA reiterates its support for Option A, an improved version of the current approach, outlining separately the entry/exit fees, the ongoing charges and the presence of performance fees. We do not support a summary measure of charges, either in percentage form or in cash terms, as assumptions must be made regarding the holding period, and entry and exit fees vary by Member State, distributor and sometimes from client to client (in the KID only the maximum would be shown). A summary charge figure would therefore be almost always incorrect, unhelpful and misleading for investors. We reiterate our opinion that a warning explaining the impact of entry and exit fees could be added to the KID and would be more helpful than a combined figure for charges. A more accurate calculation of charges can only be provided by distributors, on the basis of the exact fees paid by investors; alternatively, a link could be provided to a website tool where the investor could perform the calculations directly, using the correct inputs.

With regard to the table showing cash costs, EFAMA believes it is also very misleading for investors, as it requires an assumption of future returns, which might be misunderstood by investors as a promise or a guarantee of performance. The variants tested during Phase I of consumer testing showed also another serious flaw: the investment amount was shown as constant in the table, with rising costs in the next column (although the calculation actually assumed a 5% return). On such a basis, investors would assume that their investment is eaten up by huge fees, with no positive return.

Another reason to reject Option B is that in some Member States the exact fees (in cash terms) paid or retroceded to intermediaries must be presented to fund investors, and the danger exists that they could add the two together, although the distribution fees are actually part of the costs in the KID, and not paid on top of them.

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

EFAMA agrees with CESR that Option 1 (ex-post figures) is the best one.

We wish to point out, however, that Para. 18 still refers to audited fund accounts. If the fund's fiscal year is different, audited account figures would be used in a KID for charges, while other elements would be based on the calendar year. The use of audited vs. unaudited figures needs to be clarified by CESR, carefully weighing comparability among funds vs. certainty of calculated figures.

Some EFAMA members oppose the use of the wording "ongoing charges" instead of TER, as it suggests continuity in the amount charged and would therefore be misleading for investors.

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?

EFAMA agrees with the methodology proposed in Annex B regarding items to be included in the ongoing charges and for harmonizing the calculation, except in the case of fund of funds (see below).

It is advisable to exclude from the calculation of ongoing charges the fees charged by the fund <u>for the benefit of the fund</u> to protect existing unitholders from dilution effects of issuance and redemption of units.

The exclusion for transaction-related costs in Para. 1.5. should be modified. CESR states that it 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." However, the exclusion from the ongoing charges in the KID should be extended to any payments to the above entities when they are parties to a transaction and not providing a service (i.e. when a depositary is the counterparty in a foreign exchange transaction any fees would fall under the exemption, but custodian transaction charges debited to the fund for processing transactions executed with a broker would be included in ongoing charges).

Regarding fund of funds (Para. 1.7 of Annex B), a majority of EFAMA members does not find the calculation methodologies proposed by CESR to be necessary. Due to the fact that information on ongoing costs for the underlying funds are often not available or outdated at the time when the fund of funds needs to make its calculation, many assumptions on ongoing costs would be required. Such assumptions would not be helpful to investors and lead to the presentation of inaccurate figures which investors might mistake for actual costs. It should be sufficient instead to disclose the ongoing charges for the fund of funds, plus the maximum allowable ongoing charges figures for the underlying funds (if available), as already practiced in some Member States.

However, should a calculation be required that includes also ongoing charges for underlying funds, the method proposed under Para. 2.6 (b) second clause ("some other method of presentation is adopted which shows the ongoing charges of the investing UCITS and the underlying CIUs separately") would be preferable for some EFAMA members.

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?

EFAMA agrees with all the above CESR proposals.

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?

Almost all EFAMA members agree with CESR's proposal not to show transaction costs, but to highlight their impact through a warning to investors. One EFAMA member, however, believes that transaction costs should continue to be shown (as they currently are in their Member State) and a warning is therefore unnecessary.

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

EFAMA agrees in principle with the use of the warning, but suggests eliminating "slightly", as the word is too vague. Besides, there could be unforeseen, more than slight variations in the ongoing charges due to circumstances out of the investment managers' control.

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

The impact of fixed costs may increase under certain market conditions, for instance when the assets under management decrease unexpectedly and significantly.

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?

Many EFAMA members agree with CESR's proposal.

On the contrary, a considerable number of our members are of the opinion that it should not be required to make estimates about ongoing charges for new funds. Such estimates would not be feasible due to a variety of unforeseeable factors, and would be misleading for investors, who would think they cannot be exceeded. In case the ex-post fees are actually higher, investment managers may be held liable under civil law. It should be sufficient for new funds to display the annual management fee together with a clear warning about the impact of possible further costs.

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?

Most EFAMA members agree with the proposal (see our reply to questions 67-68).

EFAMA members believe it would be useful to harmonize the concept of materiality. Further study would be required to make suggestions on a definition.

There are different viewpoints on how materiality could be defined, for example:

- following accounting or auditing standards;
- using a percentage change in the charges (for example, an increase of 10% or more in charges would be considered "material");
- considering 50 basis points or half the current TER (whichever is lower) as material.

Regarding the wording proposed, it might be worthwhile making the following addition for clarification purposes: "…The fund's annual report ***for the financial year …..*** will include detail on the exact charges made."

We remain at CESR's disposal for any clarification that may be required.

Peter De Proft
Director General

15 May 2009

<u>Annex I</u>

The Risk/ Reward indicator proposed by the consultation is not adapted

An appropriate Risk/ Reward indicator should be inclusive

In point 1.2 Option B, page 8 to 13, the consultation paper proposes a synthetic indicator, which is based on volatility. This indicator is not adapted to Structured Funds. We see this as a big failure. For the sake of clarity for investors, and for the sake of a level playing field between all types of products, a synthetic indicator should be inclusive of all types of funds.

The proposed indicator is not adapted to all Funds

The consultation paper proposes the use of historical volatility as a measure of risk of Structured Funds, as for any other type of UCITS funds.
The consultation points out that with respect to Structured Funds "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 history can be deemed representative of the fund's current allocation or suitable for the estimation of its volatility".
Consequently, the consultation proposes the use of the historical volatility of the initial replicating portfolio for fixed maturity funds ("delta representation") and the volatility of the "current mix" for infinite maturity products.
Such use is however not appropriate, because, simply put, volatility is not a relevant risk measure for Structured Funds, and for many other funds as well.

The proposed indicator is not adapted to many other categories of funds

The proposed indicator is somewhat acceptable only for monetary funds, funds invested in bonds in a constant proportion and funds invested in standard equities with a constant proportion, to the extent that such funds can be seen as providing a log-normal distribution of return.
For all the rest of the universe, the proposed indicator is not appropriate to evaluate the risks. This is not only the case for Structured Funds but also for any quantitative strategy, for any fund with a variable leverage etc.
It cannot take into account any degree of exposure to alternative strategies. As long as strategies use non linear instruments, like derivatives, it is a well-know fact that volatility is not adapted. For example, the EU Commission recommandation on derivatives[3] proposes only three methods to compute the risks. See recital 5: "*It is therefore necessary to recommend possible approaches of market risk measurement, by clarifying the conditions for the use of the following types of methodologies: the commitment approach; the Value-at-risk approach (VaR-approach) and stress tests*". The recommendation

[3] Commission Recommendation 2004/383/EC of 27 April 2004 on the use of financial derivative instruments for undertakings for collective investment in transferable securities (UCITS) - http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:32004H0383R(01):EN:HTML

would not propose the use of volatility, because it is a know fact that it would not make sense.
In short, any type of sophisticated fund is excluded by this indicator. Very simple funds may be covered by this approach, because we can assume that they have log-normal returns and that, therefore, volatility has some relation to the risk of loss.

The proposed indicator is also not adapted because it is a short term indicator, that does not take into account the holding period

The idea behind volatility is that the risk of a fund can be determined at a given time independently from the investment horizon.
This is wrong. One of the basic asset management rules is that the appropriate product depends on the horizon of the investment. Volatility is a very short indicator of risk. It may be appropriate for somebody that wishes to invest for only a week or a few months, but it is not appropriate for somebody that wishes to invest for a few years.
Indeed, in its February 2008 advice to the European Commission[4], CESR rightly mentions in point 5.31: “the investment horizon is one of the important features an investor and their adviser should be looking at”.
What is important for an investor is his level of risk over a long term period. Investors need to know, through the risk indicator, whether they are likely or not to lose a significant part of their capital. This is what really matters to them.
What are we trying to achieve: a short term view of risk in order to allow investor to speculate, or a long term view of risks which is able to guide them for a long term investment in which they can invest their savings?

Recent market events have shown how misleading a short term indicator like volatility can be

Realized volatility at the beginning of 2007 was at an all-time low, and therefore using volatility as a risk measure would have proved a very poor indicator in the light of the recent crisis, where a typical classical equity fund has lost more than 50% in only a few months.
This illustrates perfectly why volatility is a poor and misleading indicator of risks.
Volatility is nothing more than an indication of the short term “vibration” of the returns.
It has nothing to do with actual risks of loss. Only in the few cases where volatility is related to the risk of loss, through normal distributions, is volatility appropriate.

Value at Risk is a more appropriate indicator of risks

<u>What is Value at Risk?</u>

VaR is the usual quantitative tool to calculate the risk of loss over a certain period. Value at Risk (VaR) is a widely used measure of the risk of loss on a specific portfolio of

[4] CESR’s advice to the European Commission on the content and form of Key Information Document disclosures for UCITS. Ref. CESR/08-087 http://www.cesr-eu.org/index.php?page=contenu_groups&id=28&docmore=1#doc

financial assets. Indeed VaR is the method that is recommended by the European Commission for the management of derivatives risks in UCITS[5].
For a given portfolio, probability and time horizon, VaR is defined as a threshold value such that the probability that the mark-to-market loss on the portfolio over the given time horizon exceeds this value (assuming normal markets and no trading) is the given probability level.
For example, if a Fund has a 5 year 99% VaR of 20% , there is a 1% probability that the portfolio will fall in value by more than 20% over a 5 year period, assuming markets are normal, and the Fund keeps the same investment policy.

<u>How to compute VaR for Structured Funds?</u>

For Structured Fund with a fixed maturity, we recommend to compute the historical VaR at maturity of the fund using the back-tested data of the fund, by taking the 1% worst performances.
These calculations are very easy and could be put in place by any asset manager. Regulators' control would also be easy.
The conditions in which the back-tests are made could be left to level 3. Alternatively could be determined some guidelines at level 2. For example, we would ask for 5 years of simulations in order to compute the back-test.

<u>How to compute VaR for "classical funds"</u>

For simple funds, we would calculate a "gaussian" 5-year VaR, considering that their distribution is log-normal. We would therefore deduct the VaR from the volatility. This is very easy to compute because such VaR is proportional to volatility.
Computation would therefore not be more difficult than the computation of volatility.

<u>We wish to keep the CESR consultation' idea, which is to have 7 brackets of risks</u>

We would use the log-normal distribution to give equivalent positions on the scale to:

- volatility for "classical funds";

- VaR for other funds.

In order to help regulators and asset managers, CESR would simply publish the following table:

Level of risk	VaR	Equivalent volatility for simple funds
Level 1	0 (capital guarantee)	0%
Level 2	0 < VaR < 10%	… < Vol < …
Level 3	10% < VaR < 20%	… < Vol < …

[5] Commission Recommendation 2004/383/EC of 27 April 2004 on the use of financial derivative instruments for undertakings for collective investment in transferable securities (UCITS) - http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:32004H0383R(01):EN:HTML

Level 4	20% < VaR < 30%	… < Vol < …
Level 5	30% < VaR < 40%	… < Vol < …
Level 6	40% < VaR < 50%	… < Vol < …
Level 7	60% < VaR	… < Vol

The asset managers would therefore be able to compute easily their appropriate level of risks.