FEDERATION
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September 9th 2009

CESR CONSULTATION PAPER ON THE FORMAT AND CONTENT OF KEY INFORMATION DOCUMENT (KID) DISCLOSURES FOR UCITS

FBF'S RESPONSE

GENERAL REMARKS

1. The French Banking Federation (FBF) represents the interests of the banking industry in France. Its membership is composed of all credit institutions authorized as banks and doing business in France, *i.e.* more than 500 commercial, cooperative and mutual banks. FBF member banks have more than 25,500 permanent branches in France. They employ 500,000 people in France and around the world, and serve 48 million customers.

As universal banks, French credit institutions are directly and highly impacted by the implementation of the future UCITS IV Directive as mother companies of asset managers, as depositaries, and of course as distributors.

As distributors, French banks are directly and highly impacted by the commercialization of financial products from their main business lines (corporate and investment banking, intermediation, distribution) and hence are interested in the KID which has to be considered as part of a more general process described in the Retail Investment Product White Paper of the European Commission. Thus we have always considered that the current reflections of CESR about the KID would probably apply to other kind of structured securities or unit-linked insurance-life products in the near future.

This said, the FBF warmly welcomes this final consultation and its addendum on the format and content of the KID which is dedicated to the definition of a very precise benchmark on investor information.

2. The FBF's general position on the format and content of the KID can be summed up in the five following statements:

- First, CESR's proposals on the performance scenarios or on the synthetic indicator involve that there will be no real comparability between products, since the KID on classical fund will be very different from the KID on structured funds.

  The FBF recognizes the pragmatism of this approach, based on the fact that:
  - Firstly, performance scenarios are unavoidable for structured funds, since there is no track record, while it is difficult to set up performance scenarios for classical funds;

- Secondly, volatility seems to be the most significant indicator for classical funds (despite its inability to address a clear risk assessment) and Value at risk is the best indicator for structured funds.

However, the FBF points out that the absence of performance scenarios for classical funds must not be misleading for investors and, as a consequence, that it is necessary to bear in mind that the track record is not an assumption of the future performances of the fund.

Furthermore, regarding the differences between the KID of classical funds and of structured funds, it shall be clear that comparability can no more be a main purpose for the KID. The purpose of the KID becomes purely the understanding of the product, in isolation, by the investor.

- ***Concerning the risk and reward profile***, the FBF strongly believes that the presentation of the synthetic risk and reward indicator complemented by a narrative approach is the right option, provided that the synthetic indicator is equivalent for every kind of funds.

- The **proposed length** (2 pages maximum for classical funds, three pages maximum for structured funds) seems relevant. The FBF welcomes the flexibility proposed for structured funds, provided that this flexibility does not entail the readability of the KID.

  The main reason why the simplified prospectus has failed to reach its objectives is its complexity and excessive length.

- Concerning the **practical information** (section 9), the FBF considers that the two most important pieces of information for investors are the access to the valuation and the redemption possibilities and that this information shall be put together.

3. About the revision and the availability of the KID, the FBF would like to express the concern of the French banks as distributors on one area regarding *Boxes 19 and 25*:

Regarding the revision of the KID, the FBF agrees on the circumstances under which a KID should be revised (*Box 19*) and welcomes the CESR's approach to the use of Internet to provide an updated version of the KID to the investors. For distributors which have millions of clients who are holders of UCITS, this is indeed the only practical way to provide, at any time, an updated KID.

Furthermore, the FBF agrees with CESS that a rigid application of the definition of a durable medium as stated in the Distance Marketing Directive would be irrelevant, since it is obvious that distributors will use file formats (PDF, word or other software formats on Internet website) instead of floppy discs or CD-Roms or DvDs. Thus the FBF asks CESR to refer to the MiFID which defines the durable medium as following: "*Durable medium means any instrument which enables a client to store information addressed personally to that client in a way accessible for future reference for a period of time adequate for the purposes of the information and which allows the unchanged reproduction of the information stored*" (Directive 2006/73/EC of 10 August 2006, implementing Directive 2004/39/EC - MiFID, article 2).

It would be relevant to add this definition to Box 25.

SPECIFIC REMARKS

4. Content of the Key Investor Information

Questions on Box 1:
Do you agree with the proposals in Box 1?
Should the information referred to in point 9 of the box be called 'Practical information'?

In general terms, the FBF agrees with CESR's proposals for the general presentation of the KID. However, the FBF proposes:

- Firstly, as stated in the general remarks, that access to the valuation and the redemption possibilities and conditions are put in section 9 (practical information), as this information is of paramount importance for the investors. Moreover, as the KID must be fully harmonized, section 9 shall not include any details that would vary depending on the distribution chain of the fund or depending on the country where the fund is distributed;

- Secondly, that section 12 (*identification by code number*) is merged with section 3 (*name of UCITS*), in order to allow the investor to easily find on the Internet the valuation of the UCITS, which is often available through the identification code.

Questions on Box 2:
Do you agree with the proposals in Box 2?
In particular, do you agree that the maximum length of the document and the minimum acceptable point size for type should be prescribed at Level 2?
Are there any other rules that should be prescribed in relation to the appearance of the KID?

As stated in the general remarks, the **proposed length** (2 pages maximum for classical funds, three pages maximum for structured funds) seems appropriate. The FBF also welcomes the flexibility proposed for structured funds, provided that this flexibility does not entail readability of the KID. The main reason why the simplified prospectus has failed to reach its objectives is its complexity and excessive length.

With regard to the characters of readable size, the FBF points out that CESR should precisely define what would be considered as a type size of no less than 8 points, considering the differences between the software system using the type and the printing system. For example, a printing system can consider a type size of 8 points in the software system as a printed type size of 7.

Questions on Box 3:
Do you agree with the proposals in Box 3?

The FBF agrees with this proposal and welcomes CESR's clarification that the KID may be attached to, or form an integral part of, another document.

Questions on Box 4:
Do you agree with the proposals in Box 4?
In particular, do you agree that the information shown is comprehensive and provides enough detail to ensure comparability between KIDs?
Are there any other matters that should be addressed at Level 2?

The FBF agrees with these proposals.

Questions on Boxes 5A &5B:
What are your views on the advantages and disadvantages of each option described above?
Do you agree that Option B (a synthetic risk and reward indicator accompanied by a narrative) should be recommended in CESR's final advice?

Do you agree with the proposals for presentation of risk and reward in Box 5A?
Are there any other issues that CESR should consider if it decides to recommend this approach to the disclosure of risk and reward?

Do you agree with the proposals for presentation of risk and reward in Box 5B?
In particular, is the proposed methodology in Annex I capable of delivering the benefits of a synthetic indicator?
Does the methodology proposed by CESR work for all funds? If not, please provide concrete examples.

Questions on Boxes 24A & 24B
Do you agree with the above CESR proposals on performance scenarios (Boxes 24A and B)?
In particular, which option (A or B) should be recommended? If not, please suggest alternatives.

First, the FBF would like to link the question on boxes 5A & 5B with the questions on boxes 24A and 24B about structured funds, capital protected funds and other comparable UCITS.

The FBF is pleased that CESR now considers the use of a synthetic risk-reward indicator only in conjunction with a narrative explanation. The Federation has previously underlined the many difficulties and possible misunderstandings around a synthetic indicator.

Being built on past data, such an indicator could be misleading as past data can only be a useful indicator of future risk levels over limited periods of time. Furthermore, CESR's proposal of measuring risk on the basis of past volatility is only useful for traditional types of funds, but could not be used for, for example, guaranteed funds.

This said, the specific comments of the FBF about the application of a synthetic risk indicator to the structured funds are the following:

- ***Computation of the synthetic risk and return indicator for Structured Funds (BOX 5B and Annex 1)***

  The FBF agrees on the basic principle of calculating an equivalent volatility for Structured Products based on VAR, but does not agree on the fact that we should take the maximum of 2 calculations: one made for 1-year VAR and another one made for VAR at maturity. There are many compelling reasons for using only the

VAR at maturity. Please see answers to questions of the Addendum for detailed explanations.

- ***Option of BOX 24A should be preferred to BOX 24B***

The FBF reiterates the arguments expressed in the former response in April 2009 against the use of risk neutral models to predict return:

- The BOX 24 B Option is based on a methodological flaw: 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[1], 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". This principle states that we can assume the world is risk neutral when pricing an option. The price we obtain is correct not just in a risk-neutral world but in the real world as well."

  While the risk-neutral model is efficient to price option, even if the real world is not risk-neutral, the idea of the KID is to give the investor an idea of the real world risk-return profile. Thus the risk-neutral world is inappropriate. 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. Real world includes risks, and the expected return on any asset has some relation to its risks.

- 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 theoretical world to all sorts of assets.

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

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

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 - because they have less costs - and no risk.

- If the risk-neutral world is used to evaluate Structured Funds, it should also be used to evaluate other funds.

  From a level playing field standpoint, it would not make sense to provide risk-neutral probabilities on Structured Funds and not for other funds. If the return of risks is discarded for Structured Funds, it should be discarded for other funds too.

Questions on Box 6::
Do you agree with the proposals in Box 6?
In particular, do you agree that the table showing charges figures should be in a prescribed format?
Do you agree with the methodology for calculating the ongoing charges figure?

The FBF agrees, including on the table presentation on charges figures.

Questions on Box 7:
Do you agree with the proposals in Box 7? In particular, do you agree that CESR should not prescribe a specific growth rate in the methodology for calculating the illustration of the charges?

The FBF believes that a summary charges measure would be misleading, as many investors would not understand its illustrative nature.

Question on Box 8:
Do you agree with the proposals in Box 8?

The FBF agrees.

Question on Box 9:
Do you agree that a variation of 5% of the current figure is appropriate to determine whether a change is material?

Regarding the variability of the performances of certain funds and then of the attached charges, the degree of variation suggested by CESR is too low for the retail markets.. Consequently, the FBF proposes a degree of variation of 10%.

Question on Box 10:
Do you agree with the proposals in Box 10?

The FBF considers that the annual review of charges information must be based on audited accounts of UCITS, and not only on the preparation of the audited accounts.

Questions on Box 11:
Do you agree that the above CESR proposals on past performance presentation are sufficient and workable?
If not, which alternative approach would you prefer?

The FBF recognizes that performance scenarios are unavoidable for structured funds, since there is no track record, while it is difficult to set up performance scenarios for classical funds.

However, the FBF points out that the absence of performance scenarios for classical funds must not be misleading for investors and then that it is necessary to recall that the track record is not an assumption of the future performances of the fund.

Furthermore, regarding the differences between the KIDs of classical funds and of structured funds, it shall be clear that comparability can no more be a main purpose for the KID. The purpose of the KID becomes only the understanding of the product, in isolation, by the investor.

Questions on Box 12:
Do you agree that the above CESR proposals on past performance calculation are sufficient and workable?
If not, which alternative approach would you prefer?

The FBF agrees with CESR's approach

Questions on Boxes 13 and 14:
Do you agree that the above CESR proposals on material changes are sufficient and workable? If not, which alternative approach would you prefer?

The FBF agrees with CESR's approach except in the case of feeder funds when the account auditors of the master fund are not the auditors of the feeder fund. In this case, the FBF asks for 40 business days (15 more days than proposed in the general context).

Questions on Box 15:
Do you agree with the proposed approach on the inclusion of a benchmark alongside the fund past performance? If not, which alternative approach would you prefer?

The FBF agrees that benchmarks should be displayed only if the objectives and investment policy section of the KID makes reference to such a benchmark.

Questions on Box 16:
Do you agree that the above CESR proposals on the use of 'simulated' data for past performance presentation are sufficient and workable?
If not, please suggest alternatives?

The FBF agrees with CESR's approach.

Questions on Box 17:
Do you agree with the proposals in Box 17 for the content of 'practical information' disclosure?

The FBF considers that the most important information for investors is the access to the valuation and the redemption possibilities and that this information shall be put together.

Furthermore, the FBF considers that the proposed statement regarding civil liability should be written in positive terms and then proposes the following wording:
"[Insert name if investment company and management company] *may not be held liable in law for any statement contained in this document that is sincere, accurate and materially consistent with the relevant part of the fund prospectus*".

Questions on Box 18:
Do you agree with the proposals in Box 18 with regard to the use of signposts or references to other information?

The FBF agrees with CESR's approach.

Questions on Box 19:
Do you agree with the proposals in Box 19 with regard to the timing of reviews of the KID?

The FBF agrees with CESR's approach.

5. Special cases – how the KID might be adapted for particular fund structures

Box 20: Umbrella structures

The FBF agrees with CESR's approach.

Box 21: Share classes

The FBF agrees with CESR's approach.

Box 22: Fund of funds

The FBF agrees with CESR's approach.

Box 23: Feeder funds

The FBF agrees with CESR's proposals; including that a separate KID should be produced for each feeder fund.

6. Other issues

Box 25: Durable medium and use of Internet

If the FBF welcomes CESR's views on the circumstances under which a KID should be revised (*Box 19*) and the use of Internet to provide an updated version of the KID to the

investors, the application of the regulation concerning the durable medium is not really clear and could have negative effects.

Furthermore, the FBF agrees with CESS that a rigid application of the definition of a durable medium as stated in the Distance Marketing Directive would be irrelevant, since it is obvious that distributors will use file formats (PDF, word or other software formats on Internet website) instead of floppy discs or CD-Roms or DvDs. Then the FBF asks CESR to refer to the MiFID which defines the durable medium as following: "*Durable medium means any instrument which enables a client to store information addressed personally to that client in a way accessible for future reference for a period of time adequate for the purposes of the information and which allows the unchanged reproduction of the information stored*" (Directive 2006/73/EC of 10 August 2006, implementing Directive 2004/39/EC - MiFID, article 2).

It would be relevant to add this definition to Box 25.

ADDENDUM TO THE CONSULTATION PAPER

7. Definition of the volatility buckets

Questions 1 to 6:

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?*
2. *Which option (A or B) do you see as more appropriate for the KID?*
3. *Would you like to propose any other alternative for the volatility intervals? If so, please explain your reasoning.*
4. *Do you agree that introducing some rules for assessing migration is desirable?*
5. *If so, which option (2 or 3) do you think is more appropriate?*
6. *Would you like to propose any other rule for assessing migrations? If so please explain your reasoning.*

Concerning Box 2, the FBF considers that the option A is far more simple and applicable than the option B. This said, the application of a general layer to funds with volatility over 25% would lead to an equal treatment, regarding the synthetic risk indicator, between most Equity funds, and for example between a Euro Stoxx equity fund and an Emerging markets fund.

This example gives evidence of the limits of the volatility based risk indicator. In order to avoid such equal treatment between funds which present highly different risk profiles, it is proposed to keep a six layers scale with the fifth one between 10% and 30% and the sixth one over 30%.

8. Questions concerning the special case of Structured Funds

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.

The FBF agrees on the principle that VAR at maturity is calculated and then an "equivalent" volatility is inferred by a log-normal model.

However, we believe that it is not appropriate to take the maximum of the volatility that comes from the 1-year VAR and volatility that comes from the VAR at maturity. We should only calculate an equivalent volatility that comes from the VAR at maturity and use this volatility to classify the fund according to the risk scale.

The reasons why this does not seem appropriate to us are the following:

- **The consultation recognizes that "most investors in structured funds tend to hold their investment until maturity"**

  This is very true and the consequence should be that the risk indicator be calculated on that basis.

  The only reason why the consultation also suggests using the 1-year VAR is that investors are allowed to redeem the funds before maturity. This should be seen as an added flexibility for investor, but no sensible investor will ever invest in a

structured fund having the intention to exit before maturity. Therefore it is not relevant to base a risk indicator on a behavior that, in itself, does not make sense.

We believe that it would be more appropriate to add a specific disclaimer like the one already requested by the French regulator in simplified prospectuses of French structured funds: "*The fund XYZ is built on the basis of an investment on the whole life of the fund. It is therefore highly recommended to purchase shares of such funds only if your intention is to keep them until maturity of the fund. If you sell such shares early* (…)"[2].

Indeed, the text of the consultation suggests adding a "*specific disclaimer to indicate, where appropriate and relevant, that the fund might have a different (lower or higher) level of risk if the investment is held until maturity or, conversely, redeemed before that date*". Since the consultation proposes to take the highest risk of the 2, the disclaimer would only have to say that the effective risk will always be lower than the risk mentioned by the synthetic indicator. This is not relevant. Normally, a disclaimer is there to mention a potential added risk if something specific happens. Here the synthetic indicator would artificially increase the measure of risks, and then propose a disclaimer that the risk will always be lower.

- **The computation of 1-year VAR would be a quantitative nightmare**

  The computation of VAR at maturity is not based on model, but only on running the formula of the fund on past data. This is therefore burdensome but not difficult to implement. There is only a requirement to calculate 260 x 5 = 1300 values of the formula according to past data for 5 years. This is burdensome but manageable.

  Calculation the 1-year VAR, as shown by the consultation, is much more difficult. It would imply calculating 1300 prices of the fund according to past data. Each price to be calculated would be a full exercise and would be reproduced 1300 times.

  We believe that no asset manager currently has the systems to do such calculations every year on each structured fund. New computing chains would have to be built and the cost for the industry may be quite significant. And all this added work would be required only to calculate data that, in fact, are not relevant to investors, and require a disclaimer to mention that the real risks may be lower.

- **Using only VAR at maturity would not create any advantage for Structured Funds**

  The formula that is used to compute the equivalent volatility takes fully into account the duration of the VAR.

  In other words, if the distribution of a fund is log-normal, the application of the method of Box 4 would produce an equivalent volatility equal to the historical volatility, whatever the maturity used for the calculation may be. There would be no advantage for a fund to be a structured fund, which would require finding a way to penalize them.

[2] Official French wording : "Le fonds xxx est construit dans la perspective d'un investissement pour toute la durée de vie du fonds. Il est donc fortement recommandé de n'acheter des parts de ce fonds que si vous avez l'intention de les conserver jusqu'à leur échéance prévue. Si vous revendez vos parts avant le … »

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?

The FBF agrees with such approach, provided that only VAR at maturity is used (see question 7).

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.

The solution proposed by CESR, provided that only VAR at maturity is used (see question 7), is appropriate for any type of Structured Fund.

We assume, however that the method that is described in Box 4 will be extended to Structured Fund that are based not only, as mentioned in the example, on only one index XYZ, but on several securities. In this case, it should be clarified that the performance of each security will be calculated for each of the week of the sample, and then, for each week, a simulated return at maturity of the fund will be computed.

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.

As explained above in our answer to question 7, we do not agree that a 1-year VAR should be calculated.

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 on the method.

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?

We agree, provided that the 1-year VAR approach is abandoned. We believe that the delta representation approach makes more sense than using the 1-year VAR and the VAR at maturity at the same time. The disadvantages are that the delta approach does not take into account the investment horizon and that it is also model dependent.

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.

We do not share this view: using the 1-year VAR and the VAR at maturity at the same time would give some irrational results. The delta approach is too simple because it does

not take into account the horizon of the fund, but at least it has some logic. The mix of VAR is even worse.

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.

Monte Carlo simulations are risk neutral simulations. They do not make sense in the real world. Only simulations based on past performances, as proposed by CESR, can give a real view of the risks. Also, Monte Carlo simulations would introduce a discrepancy between Structured Funds and other funds, where the SRRI is computed based on historical volatility. They would also be very difficult to compute. They would be also model and parameter dependent and would therefore introduce some degree of discretion by the asset manager.

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?

Only 1-year VAR is a problem in this respect. VAR at maturity is an objective data, which would not depend on models, and therefore not depend on the asset manager. On the contrary, 1-year VAR can be calculated only using pricing models and pricing parameters. Models are not identical among asset managers; many pricing parameters, like correlations, do not have public prices and would therefore be very dependent on the asset manager.