BNP PARIBAS

15 May 2009

Ref. CESR /09~047

BNP PARIBAS

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

BNP Paribas London Branch

10 Harewood Avenue London NW1 6AA - Tel: +44 (0)20 7595 2000 - Fax: +44 (0)20 7595 2555 - www.bnpparibas.com

This response to the CESR "Consultation paper on technical issues relating to Key Information Document ("KID") disclosures for UCITS" (the "Consultation") has been prepared by the Corporate and Investment Banking division of BNP Paribas ("BNP Paribas CIB").

BNP Paribas CIB is delighted to be able to respond to this Consultation Paper which highlights a number of issues which are important to the market. BNP Paribas CIB recognizes and agrees that it is desirable to increase transparency in UCITS and to provide information that investors can reasonably understand in order to reach investment decisions on an informed basis. However, we express some concern that the current formulation of KID may not adequately reflect the overriding principles that key investor information should include "appropriate product information about the essential characteristics of the UCITS concerned" to enable investors to reasonably understand the nature and risks of the investment product as well as providing a level playing field to all market participants.

In particular, BNP Paribas CIB considers the proposal set out in the Consultation Paper as being very detrimental to structured funds despite such funds providing useful investment solutions for investors:

- They are usually rather safe investments (often embedding a capital guarantee) and are very transparent about their risk/return profile

- They allow investors to profit from equity exposure without the classical risk of such investments. Those equity investments indirectly help financing the economy with little or no risk for investors.

BNP Paribas CIB has actively participated in the Joint Associations Committee ("JAC") discussions on this Consultation Paper and endorses the response of the JAC to the Consultation Paper, in particular the impact of the Consultation on structured funds. BNP Paribas CIB also notes that that the recent Commission Consultation on "Packaged Retail Investment Products" ("PRIPS") published on 30 April 2009 proposes to extend the use of a KID (or similar document) to other products sold to retail investors (including structured securities, structured deposits and some insurance products) and endorses the JAC statement in its submission to the Consultation Paper suggesting that a wider consultation on the contents of the KID is undertaken at this stage in order to obtain participation from stakeholders in all affected products as the findings of the current exercise in relation to the KID as used in UCITS may potentially have wider impact upon other PRIPS.

BNP Paribas' response to the Consultation Paper focuses on the two areas of the Consultation that are of most concern to it: "Risk and Reward Disclosure" and "Past Performance". We summarize below some of the salient points from our response as follows:

Risk and Reward Disclosure

BNP Paribas CIB has serious concerns over the use of and reliance upon volatility as a reliable measure of risk. In particular, volatility is a measure of short term risk whereas investors are likely to be more concerned with an analysis of their risk exposure over the recommend holding period. We strongly believe that computing the VaR over this period is much more relevant to investors. The use of VaR as a single risk indicator across all UCITS would serve a useful purpose. In addition, we are also concerned that the inclusion of an exclamation mark (!) for structured funds threatens one of the key objectives of the KID which is to provide a level playing field for all participants and would be keen to explore with CESR how far the use of the exclamation mark would extend to other PRIPS.

Past performance

Whilst there is an acceptance in the Consultation Paper that actively managed funds can demonstrate their past performances, CESR is proposing that the use of historic simulations (which are the equivalent of past performance for passively managed funds) will not be permitted in relation to structured funds. In our opinion, track record and historical simulations are valuable information for investors, allowing them to compare the performance of various products/asset classes in a consistent way. We acknowledge the fact that there is for historical simulations a gaming risk (which is also present to a lesser extent for real track record) and that a methodology needs to be defined to ensure that back-testing is not misleading. BNP Paribas CIB is making proposals to reduce this "gaming" risk and is keen to work further with CESR on this issue.

FULL RESPONSE

CHAPTER 1 – Risk and reward disclosure

Preliminary Remarks to this Chapter

We view as a very positive evolution the disclosure to investors through the KID of a synthetic risk indicator, applicable to all types of funds. The disclosure of a synthetic risk indicator would remedy an existing weakness of the documentation as currently investors in UCITS do not have all the necessary elements to assess the risks correctly and many do not differentiate risk from past performance.

We think that, ultimately, two different aspects of risk should be assessed:

- the risk involved in holding fund shares for a limited period in time (if the investor needs to exit the fund and liquidate quickly his position)
- the risk of the investor losing money for holding fund shares during the recommended investment period.

The latter notion is of particular interest for structured funds, which are specially devised for a holding period corresponding to their maturity. This risk differentiates itself from short term risk as it should express the asymmetry in risk profiles (which can have either a positive impact for capital guaranteed structured funds or a negative impact for funds encompassing an extreme risk, for example, some 'enhanced' monetary funds).

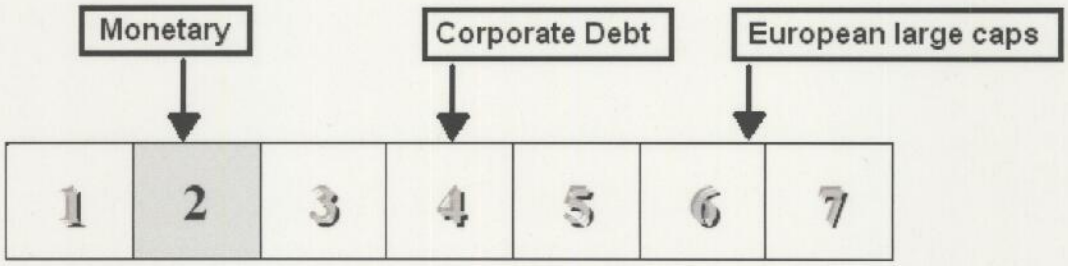
We do not think that the current proposal set out in the Consultation Paper accurately represents to investors the risks of investing in a fund: the volatility indicator is a short term risk indicator, and we think that long term risk is a much more valuable indicator and source of information for investors. Moreover, volatility is not transposable to all types of funds and valuable information about the behaviour of some of them, in particular, structured funds, can be lost. Moreover, the proposal to systematically classify some funds in the worst category is not satisfactory because in our opinion it is possible to provide investors with an appropriate level of information about the risks embedded in such funds.

In our opinion, a VaR approach is more appropriate than an approach based on a volatility measure. VaR measures tackle much more efficiently the real expression of risks, contrary to the volatility measure which makes very constraining hypotheses (for example, Gaussian distribution), and can provide a much more meaningful result. Although a VaR methodology is less easy to implement than the very straightforward computation of historical volatility, it is well known in the literature and in the industry. Although in its natural form the VaR methodology is based on historical returns, and could be viewed as having the same flaw as the volatility methodology for funds that do not have any/a long track record, this methodology can be extended naturally to structured funds through their formula, which represents a more precise modelling of their behaviour over their life. This kind of information cannot be assessed properly through a volatility computation, which is a short term indicator only.

In our opinion, the disclosure of both short and long term risk indicators is important for investors, and accordingly we would favour an approach where both indicators are shown; it is not appropriate to build a single indicator bundling together the two risks.

Finally, an important feature of the risk scale that needs to be discussed is whether the scale should be defined with respect to fixed risk figures (e.g. for the volatility indicator with fixed volatility buckets) or with respect to benchmarks. We would favour the second approach, defining the buckets for the risk indicator with respect to well defined benchmarks of specific types of

investment, e.g. the Dow Jones Euro STOXX 50 index for European equities, the Markit iBoxx index for Euro bond investment, Bloomberg EONCAP L7 Index for a monetary investment. The risk disclosure methodology would include the computation of risk indicators for those benchmarks, and the scale would be defined through buckets of distance relative to those classes. Such an approach would provide, in our view, enhanced clarity of the meaning of the risk buckets for final investors. (Please find below an example of how the scale could be presented).



In the following response we answer some selected (but not all) questions set out in the Consultation Paper. In particular, we have not answered some of the detailed questions on the implementation of volatility based ranking simply and solely because we do not think that volatility is particularly appropriate as the main (long term) risk indicator - at best it is a secondary (short term) risk indicator.

Questions for the consultation

1. Would the proposed calculation methodology lead to a categorization of funds' potential risk and reward profiles which is clear, appropriate, comprehensive and easy to implement?

We think that it is more appropriate to show an indicator presented as a 'risk category' of the funds, rather than showing a numerical indicator that final investors will have difficulty understanding properly. That being said, as explained previously, volatility does not seem to be appropriate as it is a short term risk indicator and our strong preference is to show risk relative to a recommended holding period. In our opinion, appropriate risk disclosure should show both risk indicators.

2. To what extent does it provide a comprehensive approach to risks, including liquidity risk, counterparty risk etc.?

Volatility does not provide a comprehensive approach to risks. It can help to tackle short term holding risk, but does not capture or address long term risks, in particular specific crisis risks, 'tail' risks or asymmetry of the fund's risk profile (such as an embedded capital protection).

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?

Yes, but we think that no simple methodology, especially with yearly publication, can be completely fair. In particular, quick market condition changes can alter the risk picture and call for republication of a KID. We think that producing risk categories coherent to classes of investments (as proposed in the introduction) will reduce the risk of an erroneous evaluation of the risk category of a given fund, making it much more stable in time.

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?

The answer to this question depends, in our view, upon the effective bucketing. Our proposal to bucket relative to the appropriate benchmarks would permit appropriate discrimination. For example, in the last 5 years, a typical long European equity fund (benchmarked on Dow Jones Eurostoxx50 Index) realized a 3 years weekly volatility in the 10%-30% range. A 10-30 volatility bucket for a single risk category would not have allowed the correct discrimination between funds.

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?

Certainly funds with no or little track record must bear specific risk categorization; however, in our opinion the proposed VaR methodology will provide a coherent risk indicator for structured funds and market funds and accordingly no specific risk add-on will be needed. Moreover, a risk add-on would be very detrimental to structured funds which provide useful investments.

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?

No. In our opinion, the volatility methodology introduces a bias against structured funds that is not necessary and is addressed correctly by the adoption of a VaR methodology.

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?

See question 5

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?

See question 5

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?

Yes. We agree that category 7 should be the higher risk category, but we hope that an appropriate methodology would take into account event risk and avoid the specific categorization of some funds.

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?

Yes. Funds with long term behaviour, with distribution asymmetry or tail risks will not be correctly taken into account by a volatility indicator. We consider that a VaR indicator is the more appropriate solution and would be a more appropriate indicator for "all" types of funds.

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

The proposed volatility methodology is straightforward to implement. However, we do not think that it provides sufficient or accurate insight on the real risks, and therefore we would propose a VAR methodology. The latter is very well known in literature and in the industry, and is quite easy to implement, especially for market funds. Implementation may be less straightforward for structured funds, but the providers of these funds are much more technical and used to this technology. Moreover, regulators already supervise VaR methodologies for some categories of funds.

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?

As explained in the preliminary remarks to this Chapter, we think that a non-linear scale is necessary and that a strict numeric description will not be sufficient to enable clear categorization. We think that categories should be defined with respect to benchmark investments to make the categories more understandable for investors.

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

We think that the categories could be described by two numbers, differentiating short term and long term risk for the investor (The '!' modifier would not be necessary in our view if the relevant risk methodology could encompass all kinds of risks.

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

No, see question 5.

CHAPTER 2 – Past Performance

Preliminary Remarks to this Chapter

Notwithstanding any disclaimers about past performance not being a guarantee or even a fair predictor of future results, in our experience most investors will look at past performance for guidance about the potential returns of a particular fund. It is, therefore, of paramount importance that the presentation of past performance:

- be fair, clear and not misleading for the retail investor, and

- helps the investor to compare different investment options, not only within the same asset class (e.g. a selection of large cap European equity funds benchmarked on the Stoxx600) but also across different market segments, asset classes and strategies (e.g. a corporate bond fund, an emerging market equity fund and a multi-asset quantitative strategy fund).

While the latter comparison could be viewed as unorthodox by investment professionals, in practice it is the choice retail investors will be making, often based on very little information. It is our view that investors should be provided through the KID with as much information as possible, not only about the fund manager's performance, but also about the performance of the related market. This is already the approach taken by CESR with respect to the synthetic risk indicator which will in particular help the investors in assessing the level of risk pertaining to different asset classes. We believe that this approach should also be pursued with respect to performance presentation in order to help investors take an informed decision about risk vs. reward.

In our opinion, this information should be presented as much as possible in a generic manner for all type of funds, including structured funds, and should not be biased by the different length of track records of different funds. While we do understand the value of a long and real track record as a demonstration of the manager's capability to achieve the investment objective in a consistent manner over time, we think that the exclusive presentation of a real track record unduly limits the information given to investors, which can eventually mislead them. Furthermore, it creates a barrier to entry which favours some long established managers and discriminates against some other, potentially safer solutions such as structured or risk managed funds.

BNP Paribas CIB favours the use of proxies and back-tests, with the appropriate narrative making it clear in simple and unambiguous language what these concepts signify.

Questions for the consultation

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

In our opinion, the yearly bar chart presentation is appropriate and is much fairer and less misleading than the practice of line charts against benchmark, where past accumulated performance could easily divert the attention from recent underperformance (see exhibit 1).

However, it is not sufficient. In particular, the bar chart presentation cannot operate for all types of funds, namely for structured funds. In addition, a calendar yearly period view is only a very partial one and is not appropriate for all funds. We would therefore recommend that, in addition to the yearly bar chart view, past performance should also be presented in terms of return distribution over the recommended holding period (See exhibit 2). This view is appropriate for all funds, including structured funds. It helps give the investor a fair idea of the past performance over periods which are adequate with the fund's nature and risk.

We also form the view, that in terms of lengths of the presented performance, KID should as far as possible show a full market cycle. A standard period of 10 years for all funds seems good practice. Obviously, this raises the question of the necessity of the presentation of a proxy performance. We present our view on this topic in more detail in our answers to questions 38 and 39.

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?

In our opinion, this risk is increasingly limited, provided that the basic rules prescribed by CESR (in particular the existence of a scale on the Y axis and the % performance labels on top of the bars) are observed.

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

No. In our opinion a more prescriptive approach is not necessary as far as the bar chart itself is concerned. However, we believe that some prescription should be made regarding the presentation of real track record vs. proxy or pro-forma performance. Our suggestion is that the real track record data should be presented in solid bars of any colour (including solid border empty – or white – bars), while proxy performance should be shown in dotted border bars of a much lighter shade of the same colour (including doted border empty bars). See exhibit 1 for an illustration.

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

Yes.

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

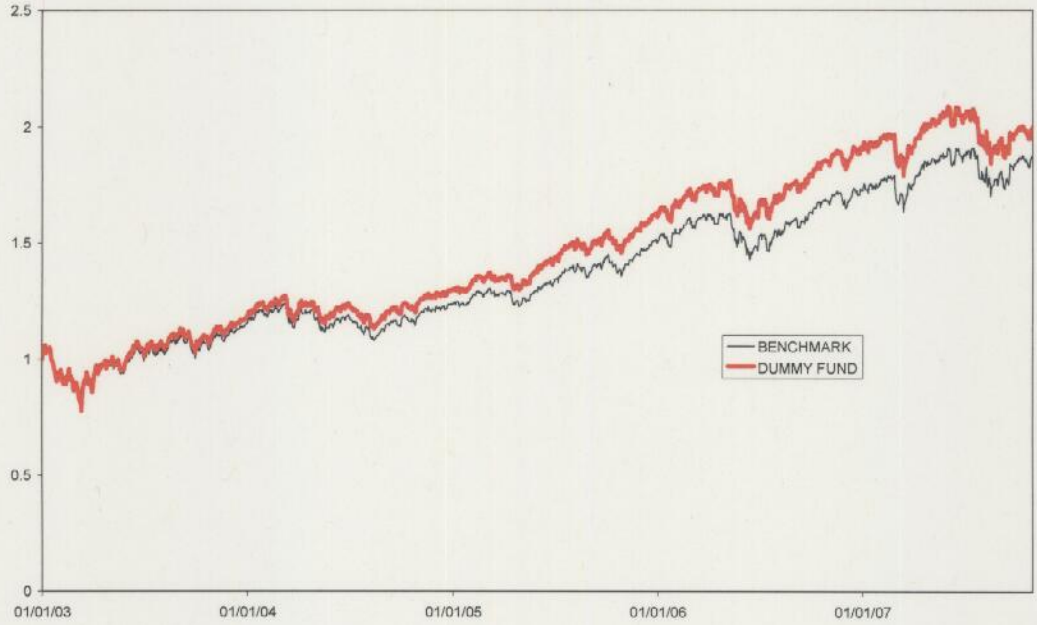
The proposed technical recommendations are helpful and workable, but not sufficient. We have suggested additions which we argue make sense in our previous answers.

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

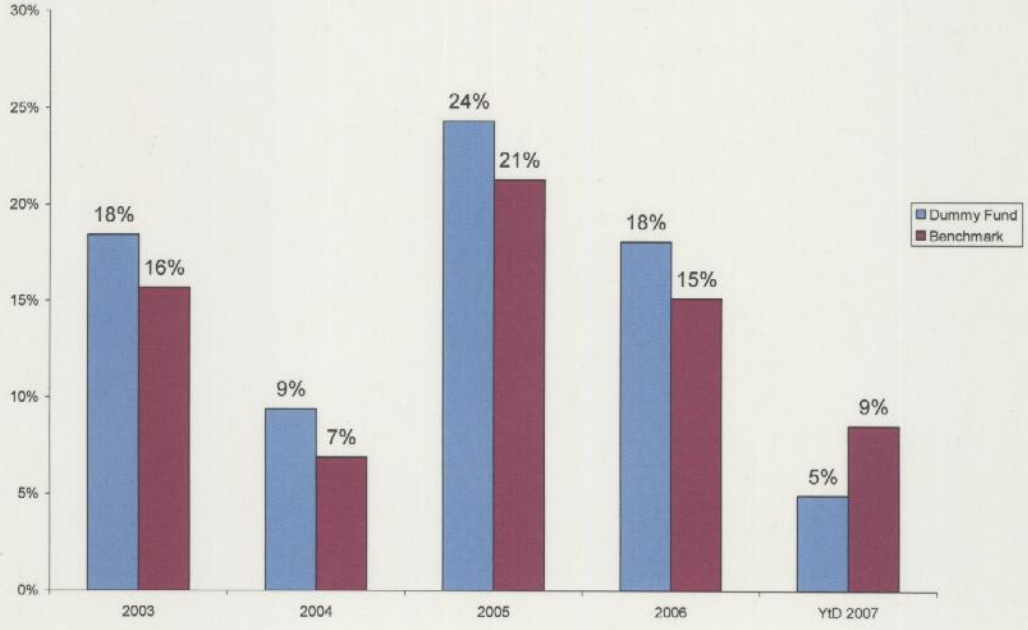
No.

Exhibit 1: line chart versus yearly bar chart

Example of misleading presentation:



Correct presentation of the same data (real track record only):



Suggested completion of data by proxy to present 10 years of data:

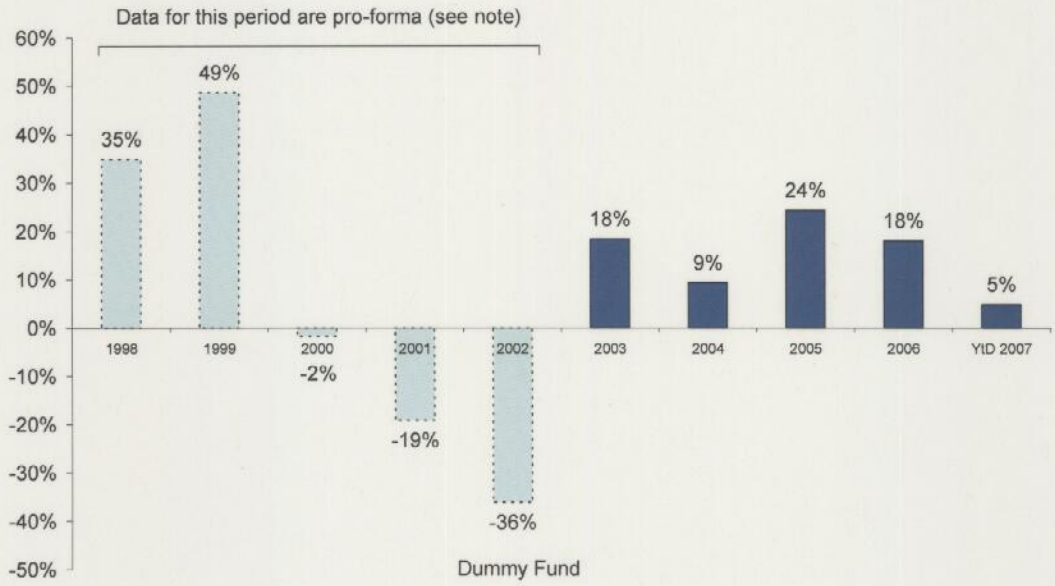
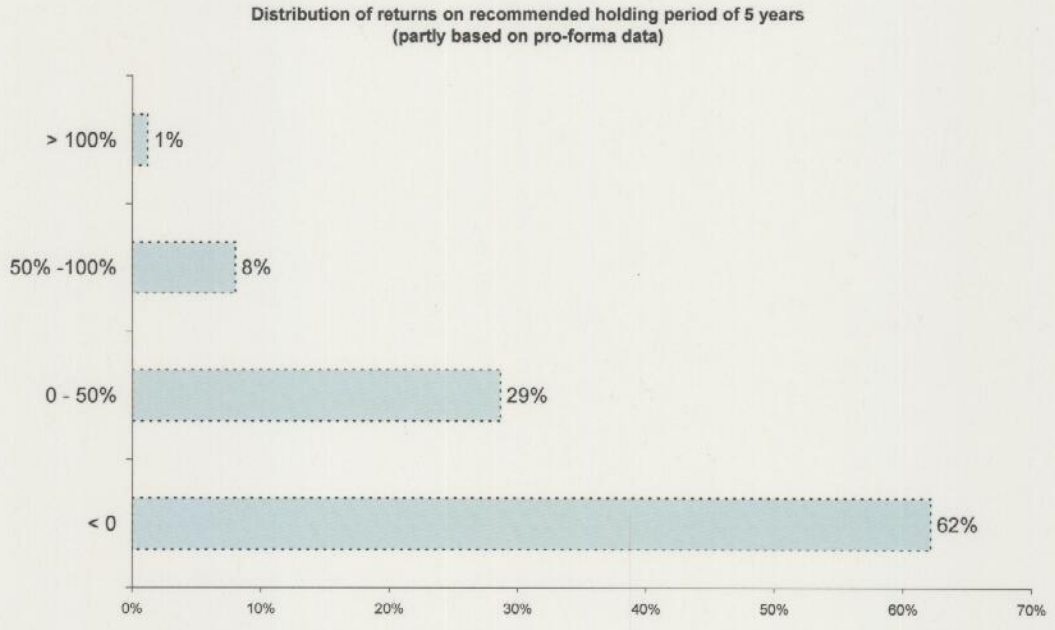


Exhibit 2:

Suggested view by distribution of returns on **recommended holding period of 5 years** (based on same data!)



'Simulated' data for past performance

Questions for the consultation

38. Does the proposed recommendation rejecting the use of a benchmark as a proxy for non-existent performance data provide appropriate investor protection?

No. It is our view that the rejection of proxy data can be harmful to 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?

To the extent that the individual investor will often take a decision based **solely** on the presented data, it would be beneficial for investor protection that the data is presented on a standardised time span to take into account the effect of market cycles. We suggest that 10 years is a reasonable time span, often encompassing at least one full market cycle.

Limiting the offer to funds which have a 10 year actual track record is neither practicable nor advisable. Therefore, there is a need to complete the data with a benchmark, proxy, or pro-forma simulation of the fund's strategy (for quantitative funds).

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

We believe that these conditions are relatively easy to achieve:

- For funds which have a defined asset mix exposure ("long only funds"), the relevant benchmark can be taken as a proxy, after applying the fund's total fees, expenses and trading costs to the benchmark's performance. The presentation of this data could be along the lines discussed above, with a note explaining which index has been taken as the proxy.
- For algorithmic strategy funds, the algorithms using historical data should be run on a pro-forma basis, including all relevant fees, expenses and trading costs. Some strategies can be difficult to simulate 10 years back in time, in particular whenever difficult to access market data is required (such as implied market volatility parameters), and in an extreme case where such data would not be available, a shorter pro-forma could be produced and approved by the regulator, with an appropriate note explaining that the strategy could not be back-tested further.

NB: For "long only funds" and for strategy funds, such performance could be presented both as a yearly bar chart and a distribution chart of returns over the recommended holding period.

- For structured funds, the performance of the underlying index or basket of securities should be run through the fund's formula and presented only in the form of a distribution of the fund's back-tested performance (equivalent to the distribution of returns on the recommended holding period for other funds).

When the calculation of an extension of the past performance proves impossible (e.g. discretionary absolute return funds such stock picking based long-short equity funds), it is often that the shortness of the track record is indeed a bad sign for investors. In our opinion, a narrative note should attract the investor's attention to the fact that the track record is short (ie, does not cover a full market cycle) and that it could not be extended due to the nature of the strategy.

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

1- Option A: back-testing

Questions for the consultation

45. Do you agree with the approach proposed by CESR as regards back-testing?

No. In our opinion, back-testing conveys the same useful information as track record does, namely whether, in past market conditions, the fund would have delivered a good performance. They have as little predictive power as a real track record does, but they do give to the investor information about the past. When applied to a period covering at least a full market cycle, they are probably less misleading than some real track records on a "lucky" period could be.

The issues encountered with back-testing are in our opinion two-fold:

- Presentation issues.

We understand that there may be some comprehension issues with certain formats of the back-testing presentation. However, we strongly believe that the presentation we suggest (distribution of returns in horizontal bars) is more appropriate and not misleading. We also believe that this presentation can also be suitable for all other types of funds, where returns over the recommended holding period can be shown.

- The selection of the structured product underlying in order to present a superior back-testing result.

This issue occurs mainly for structured funds based on static baskets of shares. As the selection is done *a posteriori* (in other words 'in sample'), this is relatively easy to address. In order to make this selection bias understandable and apparent to the investor, two solutions can be envisaged:

- The performance of the underlying basket can be shown against a benchmark index representing a superset of the basket (e.g. the Eurostoxx 50 index for a basket of Eurozone stocks etc.).
- Alternatively, the formula of the fund can be back-tested on a random basket of shares drawn from a superset index.
- In all cases a narrative note should point out the selection bias as a negative

Accordingly, we form the view that not only this last issue can be mitigated, but also that the vigilance of home country regulators should easily prevent any abuse of this "gaming" of the back-testing.

In summary, we are of the opinion that issues surrounding the presentation of back-testing results and the questions about selection bias can be quite easily overcome and in any case should not discount back-testing as a valid method of conveying useful information to investors.

46. Are you aware of any other merits that might support further consideration of this option?

We do think that this option ensures a level playing field for structured funds, which themselves are an interesting and often safe (relatively to some other investments) investment solution. This option should in our opinion be very seriously reconsidered by CESR.

2- Option B: prospective scenarios

Questions for the consultation

47. Do you agree that Option B is capable of meeting the Directive requirement for performance scenarios?

Yes. We agree that this kind of scenario can convey some useful information to investors.

48. Regarding the graph or table presentation, what are the technical merits and limitations of each option?

The compact character of a table presentation is welcome; however, we see it as a major difference with respect to all other performance presentation which is done in graphical format. We are also concerned that data in a table presentation might not be correctly understood or not even read by some investors – we would recommend further consumer testing on this matter. Our preference would be to favour a graphic presentation.

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?

Technical features of the structured fund payoff formula such as averaging (and to an even much greater extent formulas involving a multi-underlying product) are notoriously difficult to represent graphically and can be misinterpreted. It might be advisable that the scenarios should be accompanied by a note recommending the investor reads them together with the payoff formula.

The alternative of worked out examples where all elements of the formula are apparent and add up to the final payoff is in theory a very good approach. However, in practice, when the number of underlyings is high, even a relatively simple numerical example can be difficult for the investor to understand.

We would thus favour a graphical approach, with either a formula or a plain text explanation of the payoff mechanism readily available in the KID. Should a graphical presentation be prescribed, we believe it may be a good idea that CESR ask the UCITS providers for examples and publishes best practice samples.

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?

The standard practice is to provide at least three and at most four scenarios. We do not have a particular preference with respect to the number, but it should be prescribed. Four scenarios might lead to a bias towards the favourable ones (e.g. very favourable, favourable, median and unfavourable), while three scenarios tend to be more neutral (e.g. favourable, median and unfavourable).

The type of scenarios could possibly refer to historical patterns, for instance (based here on four scenarios just for illustration):

- a very favourable scenario: performance in the second decile of historical performance in the last 10 years
- a favourable scenario: performance in the 3rd or 4th decile of historical performance in the last 10 years

- a median scenario: performance in the 5th or 6th decile of historical performance in the last 10 years
- an unfavourable scenario: performance in the 7th or 8th decile of historical performance in the last 10 years

This approach has the advantage of linking the scenarios with real historical data, and could be favoured if our proposal regarding option A (back-testing) is unacceptable.

An alternative would be to link prospective scenarios to macro-economic scenarios, for instance:

- a favourable scenario: sustained economic growth during the next five years, with a good performance of the equity markets
- a median scenario: mixed economic environment with initial stagnation and economic recovery later
- a unfavourable scenario: continued recession and a slump in equity markets

This approach has the advantage of being actually forward looking rather than linked to historical patterns. However, it has the drawback of being more subjective. Supplying UCITS providers with a standardized set of scenarios would be obviously one solution, but it could lead to a very heavy burden of ongoing work for the regulators.

We would favour a reasonable approach where the UCITS providers can propose scenarios which are deemed to be realistic and can be challenged by the Member States regulators.

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

We are somewhat puzzled by this proposal. On the one hand, it seems like a very reasonable comparison for funds which are capital protected. However:

- it could also be a relevant comparison for ANY kind of fund, which begs the questions as to why it could not be included in the presentation of past performance for all types of funds? This would mean that a money market type of benchmark would be prescribed for comparison purposes for all kind of funds, which is very far from current practice
- the definition of the risk-free asset return itself poses some problems. It could be related to the same maturity best rated government bonds issued by one of the Member State. However, we are not convinced that this is the definition most investors would have in mind.

In our opinion, this option can be investigated further, but if prescribed for structured funds, it should be very precisely defined and the question of prescribing it for other funds in the presentation of their historical performance (in particular in the return distribution view that we suggested earlier) should at least be raised.

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

Overall, Option B is easy to implement in terms of calculations involved, but it is much more challenging in terms of presentation. In our opinion, best practice examples published regularly by CESR could be helpful in obtaining a satisfactory level of disclosure should this approach be adopted.

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

A potential question to be answered is the degree of simplification of the scenarios which is allowed and desirable in the case of a rather complex payoff formula with multiple underlyings.

3- Option C: performance scenarios based on probability tables

Questions for the consultation

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

However popular this methodology may be in certain areas of the financial world such as Economic Capital calculation, our view is that there are substantial difficulties with the methodology itself:

- The expected return of the underlying asset has to assume a certain level of "risk premium", whereby *statistically* a higher return will be compensating the investor for higher risk. The necessity of choosing a risk premium for all asset classes raises two issues, one upstream (regulators and providers level) and one downstream on the consumer level:
    - upstream, CESR would need to devise a level of risk premium for all asset classes commonly used in UCITS, and ensure that these levels are overall relevant and consistent (i.e. give a fair representation of the risk/reward couple for all asset classes)
    - downstream, expected return is a fairly delicate concept to understand for the retail investor, and it could easily mislead investors into thinking that this is return they should achieve on the "long term", or alternatively but just as wrongly the return they should get by diversifying their investments into a number of funds representing the same asset class (e.g. a number of High Yield Credit funds)
    - The "zero option", i.e. considering that all assets yield the risk free rate as expected return and that the risk premium is equal to zero whatever the asset class, is not a satisfactory solution to the first point raised above, as it would lead to the absurd conclusion that the risk free investments (or money market funds which are their closest proxy) are the best investment option for all investors.
- The other main parameter which enters into account in this kind of simulation, which is volatility, raises similar if not more difficult issues. Should historical or market implied volatility be used? How should the dependence between the asset price and its volatility be implemented? Our concern is that regulatory prescriptions in this theoretically challenging field could create more issues than answers through a false sense of scientific robustness.

Implementation considerations create challenges which are of similar if not greater amplitude, which we touch upon in our answer to question 56.

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

No. In our view, this approach is not robust enough from a principles point of view, nor practical enough from an implementation point of view to be recommended for any type of fund, be it long only, absolute return or structured.

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

No. This approach is notoriously difficult and cumbersome to implement. It requires resources (programming, access to data, computational power) which many UCITS providers lack. Furthermore, given the generally poor robustness of this methodology, differences in implementation may lead to substantial and unforeseen differences in results. Finally, due to the use of heavy IT infrastructure (computation engine, market parameters database) the

implementation will be difficult to audit. This might leave the Member States regulators in a difficult position where they approve scenarios they can hardly check or challenge.

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

Level playing field considerations should take into account at least two points:

- the methodology would very strongly favour large firms which have the adequate resources and/or the backing of a banking group versus small or independent firms
- the methodology may favour one type of fund over another, in a manner that would be difficult to foresee or control.