EuroInvestors.org

CESR's technical advice at level 2 on the format and content of Key Information Document disclosures for UCITS

Response from EuroInvestors.org

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EuroInvestors.org ("EUROINVESTORS") is the Confederation of European Investors that was formed earlier this year by about 45 investors and financial services users associations around the European Union.

On 8 July 2009, CESR published for consultation its draft advice to the European Commission on the format and content of key investor information disclosures for UCITS (Ref. CESR/09-552). The proposed disclosure, to be known as the Key Information Document (KID), will replace the current Simplified Prospectus and aims at increasing investor protection and convergence across Europe. CESR also released a summary of the key points of the draft advice of which retail investors should be aware. CESR mentioned that it is particularly keen to receive feedback on its proposals from this group of stakeholders.

General comments

CESR has worked extensively on this KID project for the last two years, and EUROINVESTORS would like to acknowledge the amount of work done and progress made by CESR, and to congratulate it for these. EUROINVESTORS feels that CESR is now getting close to fulfil the mandate given by the European Commission to design the new "KID" that will likely constitute a significant improvement in fund investors' information and protection.

Retail investors representatives have participated as much as they could or were allowed to to this project. In particular, some responded to the last CESR consultation paper (Ref. CESR/ 09-047) of March 2009. We refer to FIN-USE's[1] response to this consultation.

As mentioned in that response from last May, EUROINVESTORS also regrets that the implication of retail investors in the project teams remains unknown to-day: CESR mentioned it has worked with "a selection of external stakeholders" since February 2008 on these "technical issues". EuroInvestors is still not aware if there were any individual investors' representatives among them. We would like again CESR to disclose who these "stakeholders" are.

We are grateful to CESR to have issued a "*Summary of key points for retail investors in consultation on Key Information Document disclosures for UCITS*". It is certainly helpful and

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[1] FIN-USE is the Forum of user experts in the area of financial services established by the European Commission in 2004.

we appreciate that CESR realizes through this initiative the huge imbalance of resources available between retail investors reps and those of the financial industries. But we could not use it as the basis of our response, as we found that several key issues for retail investors are only discussed in the main 91 pages consultation document. Therefore, EUROINVESTORS wishes to point out that it is difficult for retail investors to fully analyze this thick and technical document –available in English only - in less than 2 months and in the middle of the summertime.

Format and presentation

CESR: "*The introduction of the KID is designed to bring about a step change in the quality of UCITS disclosures compared to the Simplified Prospectus. CESR makes a number of proposals designed to achieve this. These include fixing the running order of the different sections of the document, taking into account results from the consumer testing on which parts of the document investors find most or least important. CESR also recommends that the document be written in plain language and that it not exceed two A4 pages in length (although some flexibility on length is envisaged, up to a maximum of three pages, for structured UCITS). In addition, CESR proposes to prescribe a minimum font size of 8 points, although 10 points should be preferred where possible.*"

As stated in previous responses from retail investors, we are very pleased to see that a single format is being proposed and that this KID shall be written in plain language and shall not exceed two "A4" pages (except for structured funds) in length.
We would have liked to see "mock" versions of the KID in the annexes, in particular in order to check that the format rules do not allow for too much variations, as such variations would reduce the comparability of the KIDs of various funds, and therefore make them less understandable and more difficult to read for investors.
We have reservations on the minimum font size of 8 which seems very small. Has this particular feature been tested? Obviously, we would be more comfortable with 10 as a minimum size, keeping the 8 one only for details if applicable.

Objectives and investment policy

CESR "*proposes that the KID should describe the objectives and investment policy of each UCITS in plain terms, not necessarily repeating the description in its prospectus. CESR recommends adding a statement that investors may redeem their units on request, since the consumer testing exercise showed that a significant number of investors failed to understand this essential feature of all UCITS. There are specific recommendations on the type of information that a management company should consider when it is describing its objectives and investment policy, such as the existence of a benchmark, the types of financial instrument in which the fund can invest and the inclusion of a minimum recommended term for holding units.*"

The statement that "*investors may redeem their units on request*" must be accompanied by any constraint or penalty that could go with such a request, especially for 'target" or structured funds.

The mention by the manager of the fund of any <u>indicators of reference</u> he uses is very key for the investor. Therefore , we believe the wording of item "iv" in Box 4, page 18 should be improved this way: *" iv) whether the UCITS' management style is a pure discretionary choice within the* *investment universe <u>and does not refer to any performance indicator</u>, or whether it contemplates some reference to <u>one or several indicators</u>;…*". The word "a benchmark" may give too much latitude to the fund manager to play on the word's meaning and not disclose the performance of the benchmark in the "past performance" section. For example, an absolute return fund may argue in the "objectives and investment policy" section that he has no "benchmark", but mention in the "charges" one that he gets a performance fee for any performance above Libor. Obviously in that example Libor is clearly an indicator of reference for him and it should clearly be disclosed as such in the "objectives and investment policy" section, as well as its past performance in the relevant one.

We also believe that item d) in box 4 (<u>minimum recommended term for holding units</u>) should be a mandatory disclosure even if it is not mentioned in the full prospectus or in a marketing document. In particular, the average retail investors must be clearly informed that they should not invest in an equity fund with a short time horizon.

In general we ask that CESR's "recommended" inclusions become mandatory for all UCITS. Otherwise, they become useless, as investors would not be able to compare these key informations between various funds.

Risk and reward disclosure

CESR: "*One of the most significant elements of CESR's proposals relates to risk and reward disclosure. The consultation paper sets out two options: a synthetic risk and reward indicator (SRRI) supported by a narrative explanation versus an improved version of the narrative approach. The indicator is CESR's preferred option taking into account a range of factors, in particular improved comparability of funds. Results from the consumer testing have also shown increased engagement among investors for the indicator. CESR is seeking views on whether it should recommend the use of the indicator in its final advice, as well as on the proposed form of graphical presentation (a six-point numerical scale). Views are also sought on the merits and drawbacks of the enhanced narrative approach, and in particular whether the proposed criteria such a narrative should satisfy (including that the description be short and concise, that technical terms be avoided and that the key categories of risk be described and identified) are sufficient to deliver improved disclosures.*"

EUROINVESTORS congratulates CESR for the work done to design the "SRRI", as we are aware of the many challenges facing a single risk and reward indicator This is an ambitious but necessary work , especially in the light of the current financial crisis where even professionals obviously misestimated investments risks on many occasions (the risks of mortgage-backed securities to start with). After all, risk management is (or should be) a core competency of the asset management industry and one can manage properly only what one can measure.
EUROINVESTORS is in favor of the synthetic indicator option, for the reasons mentioned by CESR, especially the improved comparability of funds, and also because it could help the asset management industry to be more disciplined and focused in risk measurement and risk management. Option B (a synthetic risk and reward indicator accompanied by a narrative) should be recommended in CESR's final advice.

In terms of the indicator's methodology (annex 1 of the CESR Consultation Document), we refer to the FIN-USE response to the CESR March 2009 consultation as we did not find answers in the present consultation document to the following concern:
CESR proposes the historical weekly volatility over 3 years as the SRRI. Like FIN-USE, we would like CESR to research how stable such a risk indicator is.
For example, if we consider equity funds (long only), we are concerned that the last 3 year volatility measure (2006-2008) could be very different from the previous three year measure (2004-2006) – much higher in that case. We believe it is very important to measure and quantify this change before finalizing the risk indicator measure. We believe CESR should consider a longer period of reference and / or use the highest volatility 3 year period in the past in order to protect the investor against high volatility times like the one experienced since 2008.
We also question if three years only is "a sufficiently long time horizon" to capture other risks like liquidity and counterparty risks over the long term as CESR seems to claim. We have not seen data and evidence on how well this historical volatility based indicator would have captured these other risks in the past (again especially considering the recent volatility levels of equity markets and the sudden rise of liquidity and counterparty risk issues). We believe CESR should research and provide historical statistical evidence of this claim.

There again, "mock-up" versions of the KID would have been useful to assess how "plain" the accompanying narrative would be: this will be a crucial point for the average investor to understand the "rating" of a given fund.

Also, we did not have the time and resources to analyze the proposed specific methodology for "strategy funds" and for structured funds.

Charges

"CESR has considered a range of options for charges disclosures during its work on the KID. The approach proposed in the consultation paper consists of a table (the format and layout of which are prescribed) setting out clearly the different elements of the charging structure (in percentage terms), accompanied by a simple summary measure of charges presented in narrative terms and including a cash figure. The performance fee (if any) taken for the last financial year should also be disclosed. The inclusion of the summary measure of charges is designed to recognise the preference among retail investors for the use of cash figures, as confirmed by the testing exercise.
CESR has not developed specific proposals for the detailed disclosure of portfolio transaction costs, due to the technical difficulties in doing so and the challenges this information poses for retail investors in particular. However, CESR proposes that the KID include a warning if the management company feels that these costs are likely to be material."

EUROINVESTORS is very pleased to see that CESR has endorsed the inclusion of a cash figure example as the investor testing suggested. This will be a key improvement for fund investors protection in Europe as it is:

- the only information approaching the "total expense" concept (by combining the ongoing charges on assets with the charges on entries and exits into one single number),
- and the most understandable one by the average retail investor.

It is still surprising (if not amusing) to read in the CESR document the quite negative comments on this key improvement that are still coming from the asset management industry (p. 35), as all

US-based European asset managers have been doing this for decades for their US domiciled funds without any problems: why would it be different for European-domiciled funds ? Why deprive European investors of this unique synthetic and plain cost information?
Again, this is the only way the investor will get the combined impact of entry charges (on his investment) and of ongoing fees (on his asset balance).This is for example the only way to compare UCITS performance with that of substitute bank saving products, which often do not bear any entry charges.
We strongly regret that CESR does not propose to disclose this cash impact example - as for US domiciled funds - for several standardized holding periods[2] instead of only one and an undefined one. This would reduce comparability dramatically. We believe this disclosure item should be significantly more formatted than it is currently in annex 3.

Past performance

"CESR's proposed approach to presentation of past performance is based on use of a bar chart displaying up to ten years' performance, where available. There are general recommendations on the format and layout of the chart, including that it be legible and that the past performance section take up no more than half a page in the KID. In addition, CESR proposes to allow performance information to be displayed only where there is at least one calendar year's data. This is to reflect the potentially misleading effect of past performance information.
An important area that CESR tackles in its advice relates to the impact and treatment of material changes to the fund's investment policy and objectives. CESR proposes that where such a change has occurred, this should be clearly labelled on the bar chart and the data for past performance that took place before the material change should be retained."

We believe the age of a fund is already by itself an indication of its quality: under performing funds are often closed down or merged into better performing ones (we already advised CESR to investigate this widespread practice in the European asset management industry which allows to twist the meaning of past performance statistics with the extensive use of the "survivor's bias").Therefore, <u>we disagree with the 10 years maximum</u>. As recent events have again proven, 10 years is not a long enough horizon to really appreciate the performance of an equity portfolio for instance. If a fund, especially an equity fund has lasted more than 10 years, it is quite key to also get its past performance <u>from inception</u>, and, as mentioned previously, it is also often a sign of quality.

We wish to stress that not only is past performance not very meaningful and can even be misleading, but all the more so if it is presented without that of the relevant indicators of reference (see the "objectives and investment policy" section) . Not showing the comparable performance of the indicator of reference of the fund manager must remain a duly justified exception. Therefore, the language of Box 15, para. 1 (page 45) must be improved consistently with our previous request: "*If the objectives and investment policy section of the KID makes <u>any</u> reference to <u>performance indicators</u>, a bar representing the performance of these <u>indicators of reference</u> shall be included in the chart alongside each bar showing the fund's past performance."*

[2] For example 1, 3, 5 and 10 years like for US domiciled funds.

Of course, as stated by CESR, these indicators must be "*clear, fair and not misleading in relation to the performance data*". This requirement is too often violated, as we know of a number of examples where the past performance of a fund that reinvests dividends is compared to a "price" index, i.e. without reinvested dividends, although the comparable "return" index (computed with dividends reinvested) is readily available. Such a practice grossly misleads investors. It is therefore very important that CESR does not loose time in clearly enforcing its stated "advice": "where the fund reinvests income, any linked index or benchmark should be shown on the same basis" (page 45).

We do not agree with CESR's treatment of material changes to the fund's investment policy and objectives (Box 14, pp. 43-44). Like FIN-USE, we believe the other option – which removes past performance information but under the condition of specific disclosure – is preferable, as even fund data bases will not pay attention to the warning of the first option (which CESR prefers), and will not treat any differently the past performance prior to the fund's material changes. Therefore this practice can be grossly misleading. If professional financial information providers don't take it into account, how can you expect the average retail investor to do it ?

Structured funds

CESR: "*Taking into account the wide range of structures that exist in the UCITS sphere, CESR has identified a number of situations in which a tailored approach to the content of the KID might be necessary. As the display of past performance information is generally not appropriate for structured funds, CESR proposes as an alternative the inclusion of performance scenarios. These scenarios are designed to illustrate the potential performance of the fund under a range of market conditions. Two options are proposed: a prospective scenarios approach using tables or graphs (CESR's preferred option), and probability tables. CESR is seeking views on the merits and drawbacks of these two approaches.*"

EUROINVESTORS prefers option B, i.e. the tables showing the probability of certain defined events:

- achieving a negative return
- achieving a positive return worse than the risk-free rate.
- achieving a positive return equal to the risk-free rate.
- achieving a positive return better than the risk-free rate.

Indeed evidence shows that many structured funds have failed to deliver the equivalent risk free rate after costs in the past. In other words, a large number of "capital guaranteed funds" have under performed the equivalent risk free rate, generating an opportunity loss for investors. The probability-weighted performance scenarios described on page 65 (Box 24B) would warn investors against this issue, whereas option A (three prospective scenarios showing the return of the fund under "*favorable, adverse and flat market conditions*", with no indication of their probability of happening) would not.
In addition, the qualification of these three scenarios is very vague: how to make sure every fund manager will define "favorable" or "adverse" "market conditions" the same way? Thus, comparability between funds could also be hurt.
We agree that back-testing should not be used as a performance disclosure, as it could be easily manipulated by the promoter, but it can certainly be used as a point of reference for computing the probabilities of the proposed scenarios.

Practical information

CESR: "*Taking into account the results of the consumer testing, CESR proposes to shorten significantly the amount of information contained in this section of the KID so that it is limited only to the essential elements. This involves removing such information as the name of the auditor of the UCITS and how to make a complaint in relation to the management of the fund. CESR seeks views on whether its proposals strike an appropriate balance between informing the investor and making best use of the space available. CESR is also keen to receive suggestions on what the title of this section should be; CESR is proposing to refer to 'practical' rather than 'additional' information as the latter description tended not to catch the attention of investors."*

We agree that the "practical" term is preferable to "additional".