

15 May 2009

The Committee of European Securities Regulators
11-13 avenue de Friedland
75008
Paris
France

Dear Sirs,

IMA response to CESR Consultation Paper on technical issues relating to Key Information Document (KID) disclosures for UCITS

The IMA represents the UK-based investment management industry. Our Members include independent investment managers, the investment management arms of retail banks, life insurers and investment banks, and the in-house managers of occupational pension schemes. They are responsible for the management of over £3 trillion of funds, including authorised investment funds, institutional funds, private client accounts and a wide range of pooled investment vehicles. In particular, our Members represent 99% of funds under management in UK-authorised investment funds (ie authorised unit trusts and open-ended investment companies).

It is in their capacity as providers of authorised funds (and, in particular, UCITS) that our Members have a keen interest in this consultation paper and the proposals for the KID. The responsibility for production of the document will fall to them.

Overall we welcome the thrust of the proposals and agree with the need to simplify product information supplied to investors. In particular, we support the aim to make the KID a document that is clear, concise and useful to the investor and that which enables the investor to make an informed investment decision. However, it is equally important that harmonisation is achieved in the production of the KID and that investors are able reliably to compare funds cross-border. To that end, Member States should not be allowed to add to these requirements as proposed.

In its consideration of the form and content of the KID, we would urge CESR to take account of the fact that any detailed disclosure will come at an operational cost to the industry and, thus, to investors. These costs need to be outweighed, or at least matched, by material benefits to the investor. We note, and welcome, CESR's intention to carry out a further consultation on a full assessment of the costs and benefits of the policy proposals.

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We also welcome the fact that there is to be further consumer testing. Rigorous critical analysis should be applied to the construction and findings of the consumer testing, as it is important that the outcome does not merely follow what consumers say they want or like, but enables them reasonably to understand the nature and risks of the investment offered to them and, consequently, to make an investment decision on an informed basis.

In considering the feedback to this consultation, we would urge CESR to reject the inclusion of information that does not directly contribute to the achievement of this aim.

We note that, in the case of the risk and reward indicator, CESR is primarily seeking feedback on the different elements that might make up the methodology of the indicator. We have confined our response to the consultation to the technical elements, although we should make clear that the IMA does not support the proposal for a Synthetic Risk Indicator (SRI) as a method of communicating risk to investors. We regard such a method as potentially misleading in terms of performance and would prefer the use of narrative as a method of explaining risk and reward to investors. *(reference previous response to CESR dated 18 December 2008)*

It is of note that the SEC consulted on the use of such an indicator in 1995 and declined to recommend such a measure for US funds. This was on the basis that there was no consensus on the risk measure that would best serve consumers and of concerns over whether consumers might rely upon it as an indicator of performance. The SEC has continued with this approach and, indeed, no requirement to quantify risk was included in its recent proposal for a short form disclosure for mutual funds.

However, given the questions CESR has posed and given the range of views within the industry, the IMA, together with the Association of British Insurers (ABI), has jointly commissioned Fathom Consulting to conduct research into whether there exists a simple and reliable measure of investment risk, and if so how this measure could be used to categorise funds.

The full report is not yet available but the findings from this research inform our responses to the specific questions raised in the consultation paper. Our comments are also partly informed by the results of consumer testing by the ABI of the ways in which risk may most effectively be presented in graphic form.

We are in agreement with CESR's approach in the area of past performance for UCITS funds. However, we do not agree with CESR's proposals for displaying past performance for structured and guaranteed funds. The use of prospective scenarios as a method of representing performance could be misleading for investors and may appear to give a guarantee of future performance.

Also, we do not support CESR's proposal for a summary measure of charges. Information provided to investors should enable them to understand the effect of costs on the fund, the impact upon their investment and how it compares to other, similar, funds. The single summary figure would not achieve this and could be capable of being interpreted as the only charge on the fund.

The specific questions posed in the consultation paper are addressed in the attached detailed response. We would be happy to discuss this submission with you.

Yours faithfully

A handwritten signature in black ink that reads "Julie Patterson". The script is cursive and fluid, with the first letters of each word being capitalized and slightly larger than the rest of the letters.

Julie Patterson
Director, Authorised Funds and Tax

IMA's responses to CESR's specific questions

Chapter 1 – Risk and reward disclosure

IMA has, in conjunction with the Association of British Insurers (the ABI), commissioned Fathom Consulting to conduct research into:

- Whether there exists a simple and reliable measure of investment risk;
- How this measure could be used to categorise ("bucket" funds;
- What structure would be needed to implement the process; and
- Whether the same measure could/should be applied to absolute return type funds and structured products.

The full report is not yet available, but the following provides a summary of the key findings. These findings inform our responses to the specific questions raised in the consultation paper. Our comments are also partly informed by the results of consumer testing by the ABI of the ways in which risk may most effectively be presented in graphic form (i.e. not necessarily what consumers say they want but what enables them to make more effective decisions).

The search for a simple and reliable measure of risk has been a "holy grail" for finance academics since the 1950s. There are many ways of measuring risk that, *ex ante*, may be equally as good as one another, and there is no agreement about which is the "best" measure of risk.

However, work in the area of behavioural finance by academics, and more informally amongst industry professionals, would suggest that those measures that focus on "the downside" might be of more relevance to investors than ones that also take into account upside risk. There would seem to be little point in measuring risk in a way that does not reflect the way investors view risk, unless it is believed that the investors are fundamentally wrong to view risk in this way.

This research analysed eight different, commonly used, investment risk measures: maximum drawdown, range, standard deviation, VaR, Sharpe ratio, downside deviation, Sortino ratio and Beta.

A set of indices was chosen to represent as wide a range as possible of asset classes. The range of these indices (or proxies) was restricted by the availability of data and was slanted toward indices that are of particular relevance for UK funds. Therefore, for example, three indices were used to cover UK equities but only one to cover European equities. However, the analytical framework can be used for any index where there are sufficient data. For the indices used in this research there are data available in total return form on a monthly basis stretching back to 1987.

The analysis aimed to establish which risk measure produced the most consistent ranking of asset class/fund risk. It involved using monthly data to calculate the risk metric over period t to n , where $n = 12, 36$ or 60 , then ranking asset classes/funds. This exercise was repeated for $t=n+1$ to M , where $M=12$, then the asset classes/funds were ranked again.

The correlation between the two sets of ranks was calculated, using the formula:

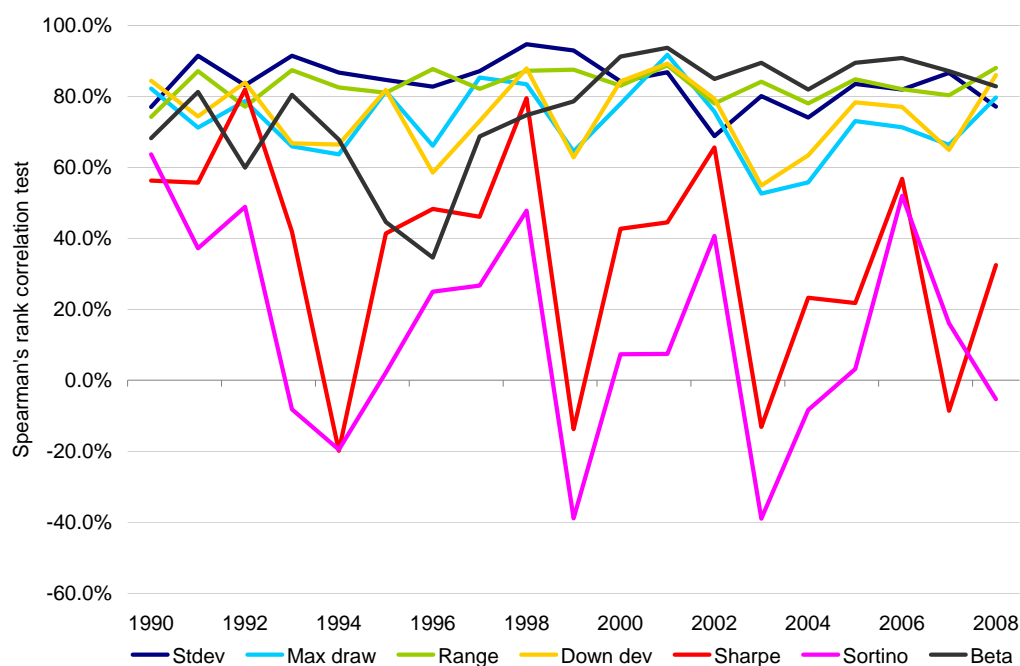
$$R_{J,K} = 1 - \frac{\sum_{i=1}^s d_i^2}{s^3 - s}$$

And the process was repeated on a rolling basis.

The results are shown in Figure 1. Standard deviation and Range appear to be the most reliable; the Sharpe and Sortino ratios the worst. Using a longer period of estimation improves the stability, but not greatly. The results for VaR are not shown on the graph as they are observationally equivalent to those for Standard Deviation. Standard Deviation, however, is operationally simpler to compute, data are more readily available and it is a more commonly used measure.

We therefore support CESR's preference for the use of Standard deviation over VaR type measures, but suggest that a measure that reflects downside risk may be of more relevance to investors.

Figure 1: *Correlation coefficients using 36 month pre-assessment and 12 month post assessment periods*



Whichever investment risk measure is used, the key question is how to get from the risk metric to the risk buckets? How do we draw the boundaries? Even the more reliable investment risk measures do not result in the same ordering of asset classes/indices, and all put direct real estate, for example, at the lower end of the risk spectrum.

The empirical results have therefore been tested against the results of a survey of investment professionals, who were asked "to bucket" a set of asset classes by expected return and expected risk. There was significant disagreement among those professionals, but the average modal result seemed justifiable and broadly in line

with the results of the analysis. Interestingly, the professionals' rankings were most closely correlated with the downside deviation risk measure.

The research also considers the frequency that an asset class might move from one bucket to another for a chosen measure. The results indicate that even for the more reliable measures and with only six buckets, the level of switching in an eighteen-month period is high, with some switches being between two buckets.

Many managers risk rate their funds (but do not "return rate" them); and a significant number resist calls for numerical ratings on the grounds that they are misleading. Most do, however, use some underlying risk methodology when designing new funds (in order, among other things, to consider how best to complete the narrative required under the current Simplified Prospectus requirements) and when reviewing their fund ranges.

Where managers do risk rate their funds, they tend to estimate risk inherent in broad asset classes rather than on individual funds. Funds are then 'fitted in' to the asset class risk spectrum. The way in which managers assess asset class risk varies greatly, but the methodologies are generally based upon measures of historic volatility. The results in terms of risk ordering seem to vary less.

Critically, managers also use their discretion based upon their professional expertise to adjust the risk order of asset classes that seem to be 'out of line'.

There is no clear consensus on how to group asset classes into risk buckets or on how many buckets to use. It is perhaps here that there seems to be the greatest diversity of approach to risk rating.

On the basis of market experience and the results of the research, it is clear that a purely automated process for risk rating and bucketing funds would be misleading and that an element of expert discretion must be applied.

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?

The empirical research demonstrates that even the more reliable historical volatility measures are not comprehensive and, without the application of expert discretion, would lead to significant fluctuations in many funds' assigned risk buckets over a short period. Moreover, the different risk ranking of e.g. the DS Japan index by different risk measures demonstrates the limitation of any one measure.

We are therefore concerned that the use of a risk measure as proposed would fail to meet certain of the tests in paragraph 7. In particular, if implemented mechanistically it would be neither stable nor robust.

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

As demonstrated by the volatility data for e.g. direct real estate, even the more reliable measures do not provide comprehensive cover of liquidity. And they cannot

reliably reflect specific counterparty risk. (The UCITS counterparty risk limits provide for some spread of counterparty risk, but not so significantly as to make it an immaterial concern for all funds.)

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?*

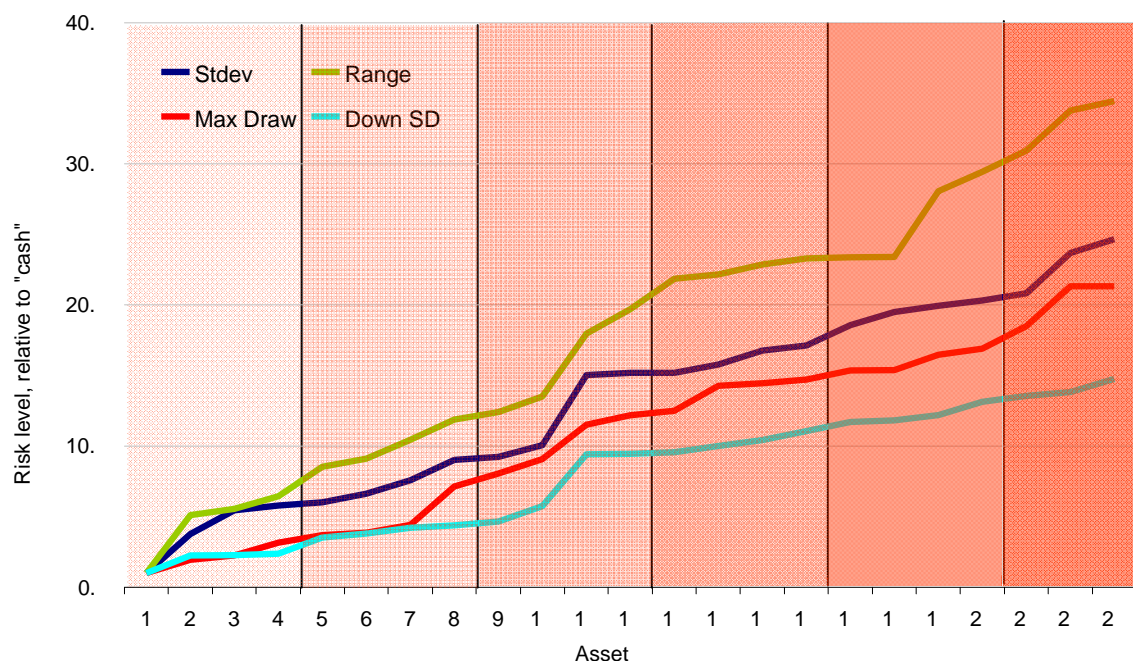
The experiences of those managers who do seek to risk rate their funds, coupled with the results of the research on risk bucketing and switching, underline the fact that a purely mechanistic approach is highly likely to result in a material number of funds being over or under rated in any one period.

4. *Does the methodology allow appropriate discrimination between funds across the universe of UCITS funds so that there is no excessive 'bunching' of funds in one or two categories?*

The ABI's own consumer research shows that the optimal number of buckets for consumers is six.

With any one of the four more reliable investment risk measures, it is possible to construct sextiles that would avoid the potential for bunching, as shown in Figure 2. If fund-specific data is used to assign risk rating, then specific numbers would have to be mandated for bucket boundaries.

Figure 2: *The Investment Risk Continuum*



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?*

If asset class data were used, then not only would that ensure consistency across the industry, but it would enable long data histories (over more than one economic

business cycle) to be used for all funds, including new ones, avoiding the need to use performance proxies.

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?

No one measure can cover all types of risk and even the more reliable investment risk measures give varying results for some asset classes and over time. The only sensible option is narrative disclosure.

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 adaption of the calculation methodology to each of these fund types?

The empirical research conducted by Fathom Consulting also considers the risk rating of absolute return type funds and structured products. The key findings are that absolute return funds should perhaps be seen as a strategy within an asset class context, while structured products should be treated separately, particularly those of the enhanced income variety.

Absolute return funds are effectively an investment strategy focussed on an asset class or mix of asset classes. Very few have adequate history to demonstrate the risk-reducing capabilities, but for those that do it would be easy to calculate the recommended risk metric. For those without a history, the starting point could be the risk metric on the mix of asset classes. An adjustment might then be needed to reflect leverage. However, the research highlights concerns about the manufacturing of a risk metric for such funds. Narrative is essential.

The research distinguishes between two generic types structured product:

- Capital guaranteed – investment in zero coupon bond, plus purchase of call option on financial market index
- Income enhanced – purchase of coupon paying bond, sale of put on financial market index

The former is easier to deal with, the latter less so since it effectively involves the investor selling insurance. The main problem with the capital guaranteed product is that it can change its “asset allocation” very dramatically. The research recommendation is that it should be ranked below equity, but above high grade corporate bonds

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?

The use of a mechanistic risk add-on implies a level of accuracy and reliability in the methodology which cannot be justified. We have not seen the results of consumer testing of the attractiveness or effectiveness of the use of an exclamation. But in the

light of the results of ABI's consumer testing, which indicates some confusion among consumers when the risk scale is numerical (does a rating of 6 mean the fund is six times more risky than a fund rated 1, for example) rather than narrative (i.e. "lower", "medium", "higher"), we have significant concerns about the use of an exclamation mark. Good narrative is essential in such cases.

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?

Systematic classification of such funds into the highest category would be grossly misleading, and since their risk profiles will vary more than for some "plain vanilla" funds, it is deeply questionable whether use of a numerical measure (which can give at best only an average risk level over time) is appropriate. Extended narrative can be the only sensible approach for such funds. To mandate otherwise could result in significant consumer detriment.

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?

We do not believe that the highest category should be used as a special category. It would be confusing and misleading. Good narrative is essential.

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?

We cannot readily identify other types of situations that are not already broadly covered in the consultation paper. In any event, for more unusual strategies, extended narrative is the only sensible way forward.

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

If asset class data were used, then they are readily available for all and over long time periods. They would therefore provide some degree of consistency across the fund market and avoid the issue of proxies for new funds. Funds invested in a range of asset classes could use the appropriate mix of index data

13. Should any other issues be taken into account regarding the calculation methodology?

The more complex and bespoke the methodology, the more costly it will be to implement and maintain, the more difficult it will be to verify independently, the more susceptible it will be to manipulation, the more likely it is to fluctuate and the more difficult it will be to explain even to informed investors. Moreover, complex methodologies risk supporting the dangerous illusion that one measure or number is the answer to all questions.

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

The ABI's own consumer research concludes that the optimal number of buckets for consumers to be able to analyse and compare funds effectively is six and that the most effective presentation is a form of thermometer or scale, as proposed by CESR.

However, that research also indicates some confusion among consumers when the risk scale is numerical. Does a rating of 6 mean the fund is six times more risky than a fund rated 1, for example? A scale with narrative seems to be more effective. With six buckets this could be e.g. minimal, lower, lower to medium, medium, medium to higher, higher. It would then be more consistent with the narrative that will accompany it.

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?

Figure 2 shows how boundaries could be decided upon in order to avoid bunching of asset classes (and therefore funds) in particular buckets.

Given the degree of switching between buckets that the empirical research shows, there will need to be some form of expert discretion in the review and maintenance of bucket boundaries, whatever measure or measures are used. If there is to be consistency within a national market, let alone EU-wide, some form of panel or forum may be needed. Such a panel would not rate individual funds *per se* but on, say, an annual basis would review bucket boundaries.

If expert discretion and some form of process to implement it are not provided for in the final proposals, then many of the key tests set out in paragraph 7 of the consultation paper, with which we agree, will not be met and there will be a real danger that the result will be increased consumer detriment.

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

We do not agree – please see response to question 14.

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

We do not agree – please see response to questions 9 and 10.

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

Members States? If so, is there any other type of warning presentation that would be more appropriate?

Please see responses to questions 8 and 14. An exclamation mark will be at best confusing and will be potentially misleading. Extended narrative is the only sensible way forward for such funds.

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?

The disclaimers set out in paragraph 90 seem sensible and appropriate. But given that the paragraph (which is in bullet point form and not prose) takes up one half of a page of A4, we are at a loss to understand how, when coupled with a graphic explanation of the risk rating of the particular fund, the risk section can take up much less than one full page, leaving even less for the other sections than currently proposed. Even the most attractive lay-outs encourage few retail investors to read the document. Resorting to small font in order to fit all the KID disclosures into two pages of A4 will make it a certainty that no retail investors will read it.

We appreciate that the overall size of the KID is not the subject of this particular consultation. But in deciding on mandated risk, performance and charges disclosures, the constraints on the length of the document cannot be ignored.

Chapter 2: Past Performance

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

We agree that the proposed framework is sufficient and appropriate. However, recent research by the ABI seems to indicate that bar charts are not the most effective way of communicating information to investors. This may be an area that CESR should subject to further consumer testing.

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?

The risk lies in additional requirements being imposed by national regulators. A harmonised document is essential and should, therefore, be clearly prescribed.

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

No, this should not be necessary.

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?

Yes.

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

The overarching requirements for the display of past performance should be that it is clear, easy to understand by the potential investor and capable of fair comparison from fund to fund.

29. Is the proposed framework on past performance calculation sufficient and appropriate to allow comparability?

Yes – although it is not clear that it would be possible for a UK provider to use Sterling past performance in the UK KID and Euro (or Euro share class) in the EU.

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?

Yes, they are workable and sufficient.

31. Do any other issues need to be addressed to achieve a sufficient level of harmonisation?

We agree with the framework proposed by CESR.

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?

For the sake of consistency and comparability we would favour the adoption of a single standard of good practice. Whilst they are broadly similar, Good Practice 2 seems to offer the information in a way that is more useful to the investor.

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?

There should be a harmonised approach to the definition of material change. To achieve this, and to maintain consistency on a cross border basis, we would suggest that this is something that should be approached on an EU-wide basis rather than through the national regulator.

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?

A benchmark should only be required to be shown where it is identified in the fund's objectives and strategy.

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?

This is a matter for national regulators at point of fund approval or subsequent Prospectus amendment.

37. Should any other issues be taken into account regarding the inclusion of a benchmark alongside the fund performance?

Any display of benchmark in other circumstances should be at the manager's discretion providing, of course, that the display of such information is clear, fair and not misleading.

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?

It is hard to see how the use of a benchmark as a proxy for performance data is likely to be of any assistance to the investor in the absence of a number of explanatory caveats. These would, in turn, limit rather than aid understanding on the part of the investor. We therefore agree with CESR's recommendation to reject its use.

41. Has CESR correctly identified all the conditions under which a track record extension could be allowed? In particular:

- iii) Do you foresee any other situations where a track record extension could be used?*
- iv) Is there a need for harmonised guidelines at a European level concerning conditions under which a track record extension could be used?*
- v) Regarding new classes of shares of an existing fund or sub-fund, is CESR's approach sufficient and appropriate?*
- vi) Regarding feeder funds, what are the merits and limits of each of the two above options? Which one should be retained?*

We note, and fully support, CESR's recommendation that in all cases where it occurs there should be a prominent disclosure that performance has been simulated.

There is a clear need for harmonisation of guidelines regarding track record at a European level to maintain a level playing field for cross border marketing of UCITS and consistency of investor protection.

CESR appears to have identified the majority of circumstances where a track record extension may be warranted. One further suggestion may be where a fund is a copy of an existing fund (where an institutional fund is offered to retail investors, for example).

With regard to the question of whether feeder funds could simulate the performance of the master fund, we would favour Option 1 as this appears simpler and easier to deliver by fund managers. Option 2, whilst achievable, incorporates the need to assess the materiality of the difference of characteristics between funds. Fund managers would, we would suggest, require some guidance on materiality from CESR if this option were to be adopted.

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?

We can see no objection to CESR's approach.

43. Has CESR identified the right conditions under which track extension for fund mergers could be allowed?

Yes.

44. Should any other issues be taken into account regarding track extension for fund mergers?

We agree with CESR's recommendation for Option c, which requires the absorbing fund to display only its past performance.

Structured and Guaranteed Funds

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

We agree with CESR's conclusion not to take forward a back-testing approach.

The issue is not simply one of the investor being capable of understanding the concept but whether back-testing provides a sufficient illustration of the range of potential outcomes for complex modified payoff products under subtly different circumstances to those assumed for the test.

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

No.

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?

We do not believe the use of prospective scenarios should be permitted. We do not believe that consumers will understand the basis of the calculation. The scenario testing assumes events and timing with the benefit of hindsight, which is clearly not what investors will experience.

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

No.

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

No.

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

Please see answer to Q.50.

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

We do not consider probability tables to be appropriate for retail investors, whom we believe would find them confusing.

We also have some concerns over how these tables would be capable of being incorporated in the KID and meet CESR's stated aim for a short, concise document that is clear and understandable by the investor.

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

We are not in favour of this route. (Please, see answers above.)

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

No, this would not be easy for UCITS providers to implement and it is doubtful that consumer testing would show that this approach would add to investors understanding.

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

We are concerned that any sort of prospective performance scenario could give investors a false sense of security regarding capital protection and be interpreted as guaranteeing certain returns. Arguably a performance scenario is a way of displaying risk and reward and would therefore be more appropriately included in that section of the KID. The risk/reward indicator would then, of course, render the scenario unnecessary.

Chapter 3: 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?

It is essential that the way in which information is provided to investors enables them more effectively to understand the costs borne by the fund, the impact that has on their investment and how the fund compares with other, similar funds. Consumers may say they prefer a certain lay-out, but if it does not improve consumers' understanding its use should not be mandated, especially if it requires a higher level of assumptions and fewer auditable figures.

We note (paragraph 16) that investors understood the purpose of the illustration of charges and that (paragraph 14) they preferred the table version. But it is of concern that the table did not add to the ability of investors to answer correctly questions about the fund.

The more detailed and descriptive the mandated disclosures, the greater the operational costs to managers (and ultimately to investors). If the potential benefits are not material, then the costs cannot be justified.

Moreover, a table of cash charges would require various assumptions to be made, as noted in paragraph 15. Not only may these assumptions be difficult for consumers to understand, they may also be misleading, which we believe is a greater concern.

For these reasons, we are not in favour of a summary measure.

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

We agree with CESR's analysis of the benefits and drawbacks of the three options under consideration, and would add two further drawbacks to options 2 and 3.

First, and relevant to both options, it will increase the operational costs for the industry (and therefore investors) in maintaining and updating these disclosures.

Second, for option 3 the use of estimates, which cannot be audited, but can only be based on the wide-ranging presumptions and views of individual management companies, make it highly likely that *ex-ante* figures will not be comparable between funds. Moreover, the use of specific figures could give the illusion of accuracy and hard fact, so be misleading for consumers.

We therefore agree with CESR that of the three options, option 1 is the best.

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?

For information, we attach the guidelines for the calculation of Total Expense Ratios used by the UK industry, which were drawn up in consultation with fund managers, accountants and auditors. We note CESR's concern that the term TER may lead investors to assume that absolutely all costs are included in the figure. The use of industry guidance does, though, ensure consistency and correctness of the figure, enabling comparisons between funds. In our experience it is the net annual return of the fund that most pre-occupies investors, and this is shown in the performance data.

We agree that performance-related fees and transactions costs should be excluded from the calculation, along with entry and exit charges.

In the interests of consistency and reliability we also agree that an *ex post* calculation based on audited accounts is most appropriate.

We suggest that listed closed-end investment companies should be excluded from the CIU definition for these purposes.

On a point of detail, in paragraph 1.3 of Annex B we believe there should be a reference to "debit through the profit and loss account ..." and not the balance sheet.

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?

We agree with CESR's recommendation and the provisional conclusion of the working group that Option 1a is preferable for the reasons given. Moreover, we note that in the UK use of performance fees is not commonly seen in mass retail market funds, but in funds targeted at the high net worth and institutional marketplace. There are a number of technical issues to consider when adopting performance-related fees, which would need to be explained to potential investors in a level of detail not appropriate for the KID.

In the light of the events of 2008 and the consequent devaluing of investors' holdings, performance fee methodologies that generate addition fees for managers/investment managers in rising markets, but that do not result in reduced fees for investors in falling markets, is under challenge. It can be particularly irksome and confusing for investors to learn that the manager is receiving performance fees because the fund produced a better return than the benchmark when the return is negative in absolute terms.

We therefore support the recommendation that the fact performance fees are charged should be prominently disclosed and described briefly, with the signposting of further information. These additional disclosures should be subject to the principle that they must be fair, clear and not misleading. The information should be available to investors on request.

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?

We agree with this proposal for the reasons set out in the consultation paper and the previous CESR advice.

We agree that information about PTRs and brokerage costs is of interest to wider market participants and therefore we support the proposal to require publication of information in the reports and accounts of UCITS. This is already a requirement in the UK; the "Statement of Recommended Practice" for the report and accounts of authorised funds (both UCITS and non-UCITS) states:

"For purchases and for sales the total before and after transaction costs should be disclosed in the notes. The notes should also show the amount of each type of transaction cost making up the total."

The SORP also requires the inclusion of the PTR in the report and accounts.

65. Do you agree with proposal to include this warning?

We agree with the proposal for the reasons given.

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

Ad valorem fees are not always calculated daily and it is not uncommon for the calculation to be based on the NAV on a single date each month. The daily charge will be a fixed amount throughout that month and will not vary as the NAV changes. When the actual charges are divided by the average daily NAV, the resultant rate, and hence the contribution to the TER, will be different to the published rate used to calculate the amounts charged. However, such fluctuations are unlikely to be significant.

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?*

We agree with the proposed manner of dealing with these issues, and note that the more significant components of the ongoing costs are usually charged on an *ad valorem* basis. The relevant issues appear to have been identified.

Alternatively, managers should be able to disclose a range in which they expect the ongoing costs to lie, based, for example, on optimistic and pessimistic estimates of the average NAV.

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 working to explain the estimated figure?*

71. *Can you suggest how materiality should be defined in the context of changes to the disclosed charges figure?*

We agree with the proposal to replace the *ex post* figure with an *ex ante* figure. We recommend that the *ex post* figure is adjusted only for the components of the charge that have changed materially.

We agree that the reasons for the estimate should be disclosed in the manner proposed and we recommend that the impact on the *ex post* figure should be disclosed.

Materiality is best defined by principles rather than a specific figure because this makes the assessment relevant to the circumstances in hand. Accounting standards and auditor judgments already provide a framework for considering of what constitutes materiality.

Guidance on TER calculation

Introduction

The requirement to publish a TER in the simplified prospectus derives from the EU UCITS Directive and is set out in FSA rules, [COLL 4 Annex 1](#)¹ ("the rules"). This note is consistent with those rules and its purpose is to assist in achieving consistency of application across all funds by clarifying some questions that have arisen. In principle, the TER represents an investor's cost of holding a pool of investments via a fund instead of investing in the assets directly.

Scope

Where there are different classes of units or shares, a separate TER calculation needs to be performed for each share class.

Source of operating costs

The rules give a list of the types of costs to be included in the TER. The following list is representative of what should be included in the TER:

- Fund management fees
- Investment management fees
- Administration fees
- Trustee or depositary fees
- Custody fees
- Audit fees
- Fund accounting fees
- Valuation fees
- Fees for shareholder services
- Registration fees and regulatory fees
- Legal and advisory fees relating to fund establishment and operation
- Other remuneration arising from fee sharing arrangements
- Performance fees (these should also be disclosed separately)

The rules specifically exclude:

- Transaction costs (including transfer taxes)
- Interest on borrowing
- Payments incurred because of derivatives
- Fees paid directly by investors, such as entry/exit fees
- Soft commissions

Paragraph 3a of the rules refers to "ex post basis, generally with reference to the fiscal year". Therefore, the cost figures will normally relate to the accounts of the last audited annual accounting period. Where there are adjustments or refunds relating to costs incurred in previous accounting periods (for example VAT reclaims in relation to the 2006 Abbey case) such amounts should not be included in the costs used to calculate the TER.

¹ Prior to 1/11/07 the TER requirements were in COB 6 Annex 2

Where a fund has more than one share class, the expenses reported in the audited accounts will not reflect the expenses attributable to any individual class. The methodology should set out how the expenses attributable to each share class will be determined and the procedures that will be adopted for reconciling the aggregate of the expenses for each class to the total reported expenses. In general, expenses should be on an "as incurred" basis. Accordingly, where adjustments are made, for example adjustments to remove interest expenses from the total expenses incurred by a class, these adjustments should reflect the actual allocation of the expenses to each class rather than any other method.

Managers need to be aware that the TER is an annual percentage rate. If a period shorter than the annual period of account would result in a material difference to an annual TER, then this should be addressed and explained.

The rules do not provide for a new fund that has not yet produced accounts. If a TER is to be prepared, the TER should be based on estimated costs and revised once the annual accounts are available.

The methodology for estimated TERs for new funds is not subject to the requirement for validation by the auditor. However, to reduce the risk of discontinuity of TERs, a consistent methodology should be used.

Transaction costs

Paragraph 2b of the rules states that fees linked to depositary duties are included within operating costs for the TER calculation. However paragraph 2c states that transaction costs relating to the portfolio are excluded. This raises the question of whether the custody fees and other expenses levied on a transactions basis should be included within operating costs for the TER calculation. The principle is that costs that relate to safekeeping are included within the TER and costs that relate to portfolio transactions are excluded.

Some depositaries charge a bundled fee. Therefore, exclusion of transaction based custody fees would result in inconsistency of treatment across funds. However, the inclusion of transaction based custody or depositary fees would also result in an inconsistency. We understand that in other jurisdictions transaction based depositary fees are excluded from TER calculations, resulting in relatively lower TERs. Therefore, in the interest of consistency of application across the EU, depositary and custody fees based on transactions should be excluded from TER calculations, unless the fees relate to safekeeping charges and other depositary services as opposed to portfolio transactions.

Where the Manager receives a fee based on portfolio transactions, that fee should be included in the TER calculation. The remuneration of the Manager is an operating cost irrespective of the basis used for its calculation.

When IAS 39 or FRS 26 is adopted in the accounts of authorised funds, the expectation is that transaction costs such as brokerage fees will be included within expenses rather than as cost of purchase or reduced sale proceeds. Such changes in accounting treatment will not change the TER calculation.

There have been some questions as to whether Stamp Duty Reserve Tax should be included in TER calculations. The FSA, in its newsletter issued in July 2005, clarified that SDRT should not be included.

NAV

Paragraph 3b of the rules refers to the use of average NAV in the TER calculation and specifies that the average should be calculated using net assets of each share class at each NAV calculation point. For consistency, this NAV calculation must relate to the same period as the costs. For example, if the costs relate to the accounting year ended 30 June 2005, and NAVs are calculated daily, then the average NAV will be the average of all daily NAV calculations over the year ended 30 June 2005.

Clearly, for a new fund the average NAV will be based on an estimate, just as the costs are estimated.

Fee sharing arrangements

Although fee sharing arrangements are not common in the UK, they do exist: for example, in relation to the income generated from stock lending activities. It is recommended that the calculation methodology should specifically document the existence or non-existence of any and all fee sharing arrangements.

Paragraph 4 of the rules is not easily read in the context of the typical operational features of a UK authorised fund. However, the intention is that fee sharing should not result in an understatement of the TER. Where, as a result of a fee sharing arrangement, a fund remunerates the Manager, or any other party, for expenses which would be included in the TER in the absence of the fee sharing arrangement, then such expenses should be included in the TER.

Change in Manager's or other fee rates

There have been some concerns that a change in fee rates at a period end might distort the TER. Paragraph 3a of the rules requires the TER to be calculated *ex post* for a historic period and not at a point in time or, indeed, on a prospective basis. Therefore, any change in fee rates is reflected in the costs for the year and the TER is generated therefrom.

Investments in other funds – the need to determine a synthetic TER

The rules require a synthetic TER to be calculated for all funds that invest 10% or more in other funds (10% or more in total).

There is therefore the question of how to determine whether the 10% point is reached. In the interest of not creating excessive costs, the 10% should be with reference to the balance sheet date. It is acknowledged that, for example, an average over the period would be a fairer assessment. However, it is thought that the cost of monitoring the percentage of investments in other funds for this purpose would create an additional level of cost.

If the Manager considers the balance sheet position to be unrepresentative, then the Manager should use a reasonable estimation technique (such as weighted average

month-end investments in other funds) to support the application or non-application of the synthetic TER requirements. The method to be used to determine whether or not the balance sheet date is unrepresentative should be included in the procedures.

Similarly, in the interest of not creating excessive costs, where it has been established that a synthetic TER is required, the synthetic TER should be calculated with reference to the average of the percentages held in the underlying funds at quarterly valuation points.

It is suggested that whether or not the Manager has funds which invest more than 10% in other funds that the methodology makes provision for such circumstance in order to be "future proofed" in this regard. If no provision is made in the calculation methodology for investment of 10% or more in other funds there is an increased risk that the need to apply the synthetic TER requirements may be overlooked.

In respect of the synthetic TER, paragraph 6 of the rules refers to "the simplified prospectus scheme's total operating costs expressed by its TER and all the costs borne by the scheme through holdings in underlying funds (i.e. those expressed by the TER of the underlying funds weighted on the basis of the simplified prospectus scheme's investment proportion) ...". The TER of the underlying funds should be obtained from their most recent published annual accounts. It is recognised that their year-ends may not coincide with the simplified prospectus scheme's year end.

Paragraph 6 also refers to subscription and redemption fees in respect of the underlying funds. For the avoidance of doubt, the subscription and redemption fees to be included in the TER are the actual fees incurred in the period.

Funds of funds

In a fund of funds where there is a rebate of the underlying funds' management fees back to the fund of funds, in order to prevent double counting of costs, the rebated amount should be deducted from costs in the TER calculation. This applies generally regardless of whether a synthetic TER is to be calculated. Thus, rebates of fees in underlying funds should be taken into account in determining the TER or the synthetic TER of a fund of funds.

Interest payable and geared funds

As paragraph 2c of the rules confirms, interest on borrowing should not be included in operating costs and NAV is clearly after borrowing. The result is that the effect of gearing is reflected in the TER.

As an example, for a leveraged fund with 50% gearing, material interest on borrowing would not be included in expenses; however, the management fees will be calculated on the gross assets, with the effect that gearing is reflected in a higher TER. For example, a fund with an annual management fee of 1.5% (no other expenses) and 50% gearing would have a TER of 2.25%.

Derivatives

The use of derivatives gives rise to certain costs and revenues associated directly with the derivative contract, for example, the cost of buying an option is the

premium payable to the counterparty. Paragraph 2c of the rules recognises such costs are directly associated with the nature of the asset class involved and excludes them from the total operating costs used in the TER.

Real property

Investment in real property assets is quite different to investment in financial instruments and there are a number of additional costs directly associated with the asset class. The rules are silent regarding the treatment of these costs. The TER should represent the costs associated with operating a fund, as listed on page 1, and should not include the additional costs associated with the day to day maintenance of the assets. We understand that in other jurisdictions costs associated directly with property assets are excluded from TER calculations, resulting in relatively lower TERs. Therefore, the exclusion of such costs maintains consistency of application across the EU. The Manager should exclude the following items from the TER:

- Costs included in the Property Expense Ratio
- Property acquisition and disposal costs (including transfer taxes)
- Property development fees
- Project management fees
- Service charges and other costs that are recoverable from tenants

It is generally the case that the Manager's fees are calculated as a flat rate of the net assets of a fund. Sometimes property funds structure Manager's remuneration in other ways and may charge separate fees for different aspects of management, for example, there may be a separate charge for the transaction management function. However, the nature of such fees remains the same and all remuneration of the Manager should be included in the TER unless it is unequivocally part of the Property Expense Ratio.

The nature of investment in real property is such that there are significant costs associated with the property assets. Although these costs are not part of the TER it is appropriate that they are reported to investors alongside the TER. Therefore real property funds should report a **Property Expense Ratio (PER)** calculated in accordance with the principles in this guidance. It is not possible to catalogue all expenses that may arise, but the following list is representative of what should be included in the PER. Such expenses should be included only to the extent that they are not recoverable from tenants. Other expenses not recorded here should follow the principles established by this guidance and this list.

- Real property management fees (such as rent collection services)
- Lease renewal costs
- Rent review fees
- Legal fees related to management of property (such as rental agreements)
- Letting costs (including marketing properties for letting)
- Property maintenance/repairs (excluding improvements)
- Ground rent and head rent
- Property insurance costs and rebates
- Non recoverable service charges
- Acquisition costs for failed transactions
- Incentivised fees in relation to the items above

It is acknowledged that in some instances a Manager will charge a bundled fee which is in part for managing the fund (including investment management) and in part for day to day management of the underlying properties. It would be inappropriate for this guidance to recommend a standard formula for unbundling such a fee to identify the day to day property management portion. However, where it is appropriate to unbundle these fees the Manager should document the circumstances in sufficient detail to satisfy the auditor's review of the methodology.

Documentation and integrity of the calculation method and its application

The calculation method should be documented in sufficient detail to enable users to understand how the average NAV and each cost type will be determined and how each cost type is to be dealt with consistently over time. Equally, without adequate documentation auditors would be unable to form a view as to whether the methodology is consistent with the requirements of the rules. In order to prevent unauthorised changes to the calculation models used by firms, there should be adequate control over the models, the application of the models, and the subsequent inclusion of TERs in the simplified prospectus and other documents. The application of the model should reflect changes in the Manager's fund range, including new circumstances such as fee sharing, performance fees, rebate of underlying management fees, investments in other funds exceeding 10% etc.

Presentation of the TER

It is recommended that the TER is stated as a percentage to two decimal places. This equates to stating the calculated amount to the nearest basis point.

Responsibility of the Manager

The Manager is responsible for the calculation of the TER in accordance with the rules and the accurate statement of TERs.

In order to discharge this responsibility the Manager should ensure that it has a methodology consistent with the rules and that there are adequate written procedures relating to the methodology and its use.

Should a Manager identify that it is unable to calculate a TER using the validated methodology (except for a new fund), the Manager should communicate that fact to the FSA.

The requirement to have the TER calculation method validated by auditors

The auditor's work relates to the consistency of the Manager's methodology to the rules and not to the application of the methodology. Having obtained validation of the methodology, there is no requirement to obtain auditor checks in respect of the application of the methodology.