



Response to CESR Consultation Paper on the Simplified Prospectus

Lipper Fitzrovia is part of Lipper, the leading global provider of fund information and analysis. Lipper remains solely focused on information, analysis, and benchmarking of funds and other collective investments.

Lipper Fitzrovia's fees and expenses research is unrivalled globally and recognised as the European industry standard. This combines the resources of Lipper, the leading fee and expense research company in the US, founded in 1973, with those of Fitzrovia, the pioneer of TERs in Europe since 1993. We are currently supporting Working Groups at both ALFI and INREV on fee metrics.

We are grateful for this opportunity to comment on the Consultation Paper and will focus our comments on Lipper Fitzrovia's area of expertise: fees and expenses.

We continue to be supportive of the European Commission's recommendation to disclose current and historic TERs in the UCITS simplified prospectus, reflecting the industry's moves for greater transparency in this area.

Our response is divided into two sections. Part I addresses several relevant questions previously highlighted in the EC's Green Paper. Part II provides Lipper Fitzrovia's TER Position Paper, which outlines key elements of our methodology, highlighting the consistency of calculations across Europe.

Part I: Relevant questions relating to TERs

Q: Are TER figures really comparable across funds and countries?

A: The TER provides the most accurate calculation of a fund/share class's annual operating expenses that drag on fund performance each year. As a result, the TER is a far better means to compare annual fund expenses than the quoted management fee.

Importantly, Lipper Fitzrovia's historically-proven methodology ensures that each fund/share class's TER is calculated on the same, consistent basis. While the breakdown of expenses within the TER may vary from fund to fund, the resulting TER reflects all annual operating expenses detailed in a fund's financial statement.

Specific aspects of Lipper Fitzrovia's methodology, highlighting its consistency and compatibility with the EC guidelines, are detailed in the "TER Position Paper" as Part II of our response.

Q: Are all the relevant charges visible to the investors?

A: The breakdown of expenses disclosed in financial statements may vary from fund to fund, and domicile to domicile, and thus visibility to investors will vary in the same way.

Lipper Fitzrovia's twelve years of unique experience in analysing funds' fees and expenses suggests that the key components for European funds are as follows (even if they are not all disclosed separately in financial statements):

- * Management/Investment Advisory
- * Valuations and Accounting) Together these two categories
- * Transfer Agency and Shareholder Servicing) cover Administration
- * Custody/Depository/Trustee
- * Audit
- * Legal
- * Directors
- * Printing and Publication
- * Distribution (approximating US mutual funds' "12b-1" fees)
- * Performance fees (which may or may not be included in the TER)
- * Remaining expenses for the vast majority of funds tend to be immaterial as individual categories (e.g. regulatory fees)

Lipper Fitzrovia provided this list to IOSCO in November 2002 and it is broadly in line with that detailed in Annex 1 of Recommendation 2004/384/EC. In our view, the above list remains the most reasonable template for disclosing a breakdown of fees and expenses that contribute to the TER.

Q: Could a clearer break-down of fees help to promote investor-driven competition between different players in the distribution process?

A: In order for investors to compare the cost of investing in different funds, clear and separate disclosure of annual ongoing costs (TERs, separate from investment-related capital costs such as brokerage commissions) and one-off costs (initial/exit charges) is most important.

For funds with multiple share classes, clear disclosure of each share class (with different one-off and/or annual costs) available to each investor would certainly be of benefit. For example, an investor might choose a different cost structure (and thus share class) depending on how long they intended to invest in a fund.

"Investor-driven competition" will partly depend on the success of the simplified prospectus in enabling investors to evaluate a range of comparable information, of which fees and expenses are only one part.

Given the above factors, it seems sensible to evaluate what impact the simplified prospectus and disclosure of TERs has had after a reasonable length of time before requiring further disclosure of fees. This would also give the opportunity to assess whether funds with insufficient fee disclosure were being "punished by investors voting with their feet" (as the Green Paper suggests).

Having said this, it is appropriate to address what are referred to as “hidden costs” in the EC’s Background Paper: distribution fees and brokerage commissions.

Distribution fees.

It is very rare for such fees to be disclosed in Europe. The most notable exceptions are among Luxembourg-domiciled funds, in particular those promoted by fund companies originally from the US. This last fact is likely to reflect that distribution fees have to be disclosed in the US as a “12b-1” fee.

In weighing up a potential requirement to disclose distribution fees, at the very least regulators should be aware of both, on the one hand, the benefits of disclosure (enabling investors and fund companies to make more like-with-like comparisons of annual fees and expenses) and, on the other hand, the problems this may cause for the majority of funds that rebate a variable portion of their management fee to distributors.

In this context, it is interesting to note recent requirements in Italy and Switzerland for each fund to disclose retrocessions to distributors in its prospectus. If such requirements allow maxima or ‘guideline’ figures, fund companies’ flexibility in paying different distribution fees should be preserved. However, for reference, in order for this figure to be disclosed separately as a component of the TER, the amount actually charged would need to be disclosed in financial statements.

Experience from the US should also be taken on board. For example, Lipper’s Global Fiduciary Review group produced a study titled “Rule 12b-1: A Vital Concept That Requires Reshaping” in 2004. This details the evolution of this fee in the US over many years, as well as quantitative analysis and suggestions on moving forward.

Among a range of conclusions, the authors suggest: “When analyzing the appropriateness of Rule 12b-1 - and all other payments made with the intention of share sales - one must accept that distribution payments are a reality. Payments to promote share sales and business growth are an essential component of the investment company industry, and they will occur whether there is an explicit outlet for distribution or not. However, within these distribution payments are built some inequities. When an advisor’s profitability is used as a source of distribution, the ability of a small complex to meet industry-standard compensation payments versus the ability of a large, well-established complex widens. Is this an acceptable inequity in the investment company industry? If stricter limits on Rule 12b-1 were imposed or if the Rule were eliminated altogether, would these inequities continue to widen, and what effects would that have on the industry?”

Brokerage commissions.

Disclosure of costs associated with trading, but outside the TER, would seem to be sensible if such information can reasonably be provided in line with other information in a fund’s financial statement. This would seem to require a significant change in accounting standards as such costs can currently not be seen. The recommendation to disclose portfolio turnover is obviously the first step on this road.

Portfolio turnover.

Having referred to portfolio turnover above, it is worth looking more closely at the current methodology. This is defined in the EC guidelines as:

$$[\text{Purchases} + \text{Sales}] - [\text{Subscriptions} + \text{Redemptions}]$$

As a percentage of a fund's average total net assets.

This methodology tries to strip out the required purchases and sales that one would expect as a result of subscriptions and redemptions, with portfolio turnover as the excess. However, if subscriptions and redemptions are reasonable and offset one another, a cash balance is likely to be sufficient for the fund not to need to keep investing (and therefore subscriptions and redemptions could exceed purchases and sales). In such a situation, this methodology may result in a *negative* portfolio turnover figure.

In addition, it appears instinctively wrong that a fund which buys and sells its entire portfolio should have a turnover of 200%, rather than 100%. At the very least, this cannot be helpful for investors.

This methodology also contrasts with the US, where the SEC requires funds to disclose portfolio turnover as follows: "Divide the lesser of amounts of purchases or sales of portfolio securities for the fiscal year by the monthly average of the value of the portfolio securities owned by the Fund during the fiscal year." (Form N-1A).

Lipper Fitzrovia calculates portfolio turnover for UK funds along the SEC's lines to measure the degree of active fund management (by taking the *lesser* of purchases and sales), and we have used this data to compare the methodology with that of the EC.

From this we can see that, not surprisingly, adding purchases and sales has the effect of roughly doubling the portfolio turnover figures compared to the SEC's methodology. Even if one were to divide $([\text{Purchases} + \text{Sales}] - [\text{Subscriptions} + \text{Redemptions}])$ by 2, the methodology seems overly complex for no distinct advantage.

The SEC methodology is a long-established, accurate and simple way to create a ratio based on voluntary rather than forced trading, because only voluntary trading is the more meaningful measure of the degree of active management.

Lipper Fitzrovia's concerns are not only that European funds might be placed at an artificial competitive disadvantage with US mutual funds as a result of dramatically different methodologies, but also that European investors will not be better served as a result.

Part II: Lipper Fitzrovia Total Expense Ratio (TER) Position Paper

Aims

The aim of this paper is to outline key elements of our Total Expense Ratio (TER) calculation methodology and how it compares with recent European recommendations, principally those contained in the European Commission (EC) document 2004/384/EC relating to the UCITS simplified prospectus.

Furthermore, this paper will illustrate how Lipper Fitzrovia's approach ensures that our TER calculations are **consistent** (not only between domiciles but also historically), **justifiable** (based upon financial statements), and **useful/relevant** for investors and fund companies.

Background

Lipper Fitzrovia's fees and expenses research is unrivalled globally and recognised as the European industry standard. This combines the resources of Lipper, the leading fee and expense research company in the US, founded in 1973, with those of Fitzrovia, the pioneer of TERs in Europe since 1993.

In addition to comprehensive US data coverage, Lipper Fitzrovia covers eleven major European fund markets and has made over 200,000 historic TER calculations. This data is used as benchmarks by the industry. Our clients manage more than US\$ 2 trillion of fund assets, and also include regulators, funds associations, auditors and others.

Lipper Fitzrovia advised the EC's UCITS Contact Committee on the calculation of TERs in November 2002. While the notes included in the EC guidelines do not provide as much detail as Lipper Fitzrovia requires to calculate TERs on a consistent basis across jurisdictions, the methodology is broadly in line with that of Lipper Fitzrovia. Our approach also ensures that one fund does not need to provide multiple TERs for multiple jurisdictions.

Average Net Assets

Lipper Fitzrovia uses the most accurate and independently verifiable way to calculate a fund's exact average net assets, using management fee data published in a fund's financial statement. If a fund has a management fee of 1% and the management fees charged in a financial statement covering 365 days are £1 million, then the exact average net assets over the accounting period must be exactly £100 million.

This calculation remains accurate whether the net asset value (NAV) calculation is daily or weekly, and the figures can be annualised if the accounting period is not exactly 365 days. This also takes into account that NAV calculations are not made at the weekend, even though a fund will accrue expenses on these days. This also reflects figures that have been audited.

The EC states that the average net assets must be calculated using figures that are based on the UCITS' net assets at each calculation of the NAV. As noted above, Lipper Fitzrovia's methodology meets this requirement.

Funds of Funds

An annual expense figure that includes underlying funds' expenses, even if this involves an element of estimation, is a reasonable aim in order to present how total operating expenses impact on a fund of funds' performance.

Lipper Fitzrovia's standard TER calculations are based on published financial statements. For funds of funds, this excludes the expenses of underlying funds. As a result, funds of funds are included in a separate section of our research and their limited use is noted.

In addition, Lipper Fitzrovia produces separate research on a range of UK-domiciled funds of funds that includes underlying funds' expenses using the portfolio holdings detailed in funds of funds' financial statements (what Lipper Fitzrovia refers to as an "inclusive" TER).

The EC states that UCITS that invest at least 10% into other funds should calculate a "synthetic" TER that includes underlying fund expenses (including the subscription and redemption fees of these underlying funds).

In the review of the Committee of European Securities Regulators' (CESR) on the implementation of the EC's recommendations on UCITS (July 2005), Belgium, Germany and Spain do not require a "synthetic" TER.

Given that underlying funds' TERs will be based on different accounting periods from the fund of funds itself, which will be available at different times, and also given that portfolio holdings will change through the year, it is likely that resulting "inclusive", "synthetic" or "summarized" TERs will vary. Despite this, this does seem to be the most reasonable means to estimate annual expenses impacting on a fund of funds' performance.

Transaction Costs

Transaction costs that a fund incurs buying or selling investments are capital costs (i.e. non-revenue items) rather than operating expenses, and these are consequently excluded from Lipper Fitzrovia's TER calculations. This is consistent with the EC guidelines as well as the TERs disclosed by US funds under Securities & Exchange Commission (SEC) requirements for many years.

Lipper Fitzrovia acknowledges that a small minority of European and offshore funds still aggregate their transaction costs under an operating expense heading, making them impossible to eliminate from the TER calculated using the financial statements alone. The inclusion of transaction costs in the TER will artificially inflate the figure, which is contrary to the interests of both the fund and the investment industry.

For this reason Lipper Fitzrovia has always encouraged fund promoters to ensure that there is adequate disclosure in the financial statements to allow operating and capital costs to be readily identified.

Impact of Change in Management Fee

Lipper Fitzrovia's TER reflects what was actually charged to a fund over an accounting period. In addition, we go beyond current disclosure requirements and calculate a separate "projected TER" that assumes the new management fee was charged throughout the accounting period (and other expenses remain equal).

Historic

The EC states that UCITS should "include a clear reference to an information source where the investor may obtain previous years'/periods' TER figures." Lipper Fitzrovia is the only source of such data across major European fund markets.

Recent Launches

All of Lipper Fitzrovia's TERs are based on published financial statements with at least 90 days accounting data. We do not estimate TERs.

The European Commission states that a new fund should provide "a reasonable estimate of expected costs". It is worth noting that in order to do this, a fund company must estimate the operating costs and the average fund size. The latter is particularly hard to estimate for an unlaunched fund, and thus the expected TER could be misleading.

Performance Fees

Lipper Fitzrovia's research includes three relevant fields: [TER], [Performance Fee] and [TER + Performance Fee].

Lipper Fitzrovia excludes performance fees from our standard TER calculation and continue to believe that two separate figures are most relevant and useful for clients and investors. The following points outline in detail why a consolidated [TER + Performance Fee] figure on its own may well cause confusion:

1. Annual operating expenses act as a drag each year on fund performance, and so if the TER is to be used as a guide to ongoing drag, it is important for a single figure to exclude performance fees (with the latter then shown separately). In a combined figure one cannot see how much is a result of performance and how much is a result of largely fixed operating expenses.

2. Performance fees are, by their very name, performance-related and so might not be payable in any given period. Nevertheless, clearly understandable information on performance fees – both their structure and what has been charged – is essential for the investment community.

3. Two funds, with otherwise identical expenses, are likely to have different TERs if performance fees were included. Furthermore, the better performer could have a higher TER. This could also create a situation where the TER of a fund could look volatile over time, when, in fact, this merely reflects the fund's performance, rather than its operating costs. Indeed the inclusion of performance fees in a TER could partly reflect wider market conditions over the accounting period.

4. A TER can sometimes be lower than a fund's total operating expenses, or even negative, if performance fees are included. This is explained as follows: performance fees must necessarily be accrued at each fund valuation point. The actual crystallisation (i.e. when it is fixed and recorded as a payment) of that performance fee might not happen for some time. Any subsequent downturn in a fund's share price will result in reduced performance fee accruals at future valuation points. This could lead to a situation where, within a particular accounting period, there is actually a reduction in the accrued performance fees.

5. The impact of performance fees in terms of a fund's net assets, if the performance goals were achieved over an accounting period, can be expressed separately (and are expressed separately in Lipper Fitzrovia's research). However, the most useful and relevant performance fee figure for investors and others is not the performance fee that was achieved in any given period (in net assets), but the performance fee structure itself (together with the fund's performance).

Recent disclosure recommendations vary in their approach to performance fees:

The European Commission states that performance fees should be included in the TER and should also be disclosed separately. In Italy, where more than half of all domiciled funds have a performance fee structure, Commissione Nazionale per le Società e la Borsa (CONSOB) states that performance fees should be included in the TER. In Germany, Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin) states that performance fees should be shown separately. In Switzerland, the Swiss Funds Association (SFA) recommends that two TERs should be published, both with and without the impact of the performance fee.

For further information, please contact:

Ed Moisson
Lipper Fitzrovia
Tel. +44 (0)20 7307 1444
www.lipperweb.com or www.lipperfitzrovia.com

Some Comments on Understanding the Total Expense Ratio

Lipper Fitzrovia has pushed for the disclosure of Total Expense Ratios (TERs) since 1993. The following comments clarify issues relating to this figure and a return reduction metric, such as the Reduction in Yield (RIY), and why both metrics have their place in improving disclosure to investors.

The TER represents the drag on fund performance caused by all annual operating expenses. It therefore improves current disclosure of **ongoing** (annual) charges. It does not replace the need for disclosure of **one-off** (initial and exit) charges borne directly by an investor, nor for a potential return reduction metric.

Criticisms that an investor “might reasonably expect that the TER might include all of the expenses to be charged to the investment” (FSA Note on Charges Disclosure) or that TERs “ignore initial charges” (Money Management, January 2007) seem disingenuous as the TER does include all annual operating expenses borne by the fund and expressed as a ratio of the fund's assets. The TER does not, and should not, do otherwise.

Return Reduction Metric

The return reduction metric is a projection based on assumptions of a growth rate, fee and expense levels, and holding period, as follows:

1. An assumption as to the length of time over which the initial charge is amortised.
2. An assumption that the maximum initial charge (as quoted by a product provider and not taking account of discounts via fund supermarket or discount broker) is actually paid by an investor. (Currently individual calculations are not made for each investor, and so cannot include the actual charges an investor has paid.)

Current disclosure in the UK also uses two further hypothetical scenarios in order to show “what you might get back”:

3. Initial size of investment, and
4. Annual growth rate

Comparisons between the annual (**ongoing**) charge figure and a combined (**ongoing** and **one-off**) figure in a return reduction metric must take this into account.

Performance Fees

Importantly, assumption 4 (above) has specific implications for funds with **performance fees** and how these can be included in a combined figure. For example, if the assumed growth rate is 6% and a performance fee has a 6% hurdle rate, no performance fees would be included. In the same way, incorporating performance fees relative to a benchmark index raises further issues.

Relative v Absolute Figures

Also on assumption 4, it is worth highlighting that the RIY relates specifically to an assumed growth rate. In other words, the combined charge figure will vary relative to the assumed growth rate, regardless of whether the absolute fees (TER and initial charges) remain the same.

Users of the RIY must therefore be aware that the assumed growth rate is consistent across funds, regardless of whether this rate is reasonable for a specific fund, and that the effect of charges will be different if the growth rate is different in practice.

To clarify, the TER is based on fees and expenses actually charged to a fund over one year.

Treatment of Income

The treatment of income/distributions paid from the fund should be made to clear to investors. The current RIY model in the UK is likely to make funds that pay out income look more expensive than funds that do not, because the assumed growth rate is reduced by such deductions.

If RIY figures are compared without detailed footnotes, it would not be obvious to investors or other observers that the growth rate is reduced by factors other than charges.

Existing Investors

A combined figure of **one-off** and **ongoing** charges is of no use to existing investors as they will have already paid the initial charge. However, the ongoing monitoring of charges – as well as performance, identity of fund manager and other factors – needs to be encouraged.

Understanding the Different Impact of Charges

There is a risk that by combining **one-off** and **ongoing** charges, investors will continue to have “a poor grasp of... how those charges can affect the value of their investment” that FSA Consultation Paper 04/18 highlights.

A combined figure does not address the fundamental difference between **one-off** charges that are paid directly by an investor from **ongoing** charges (the TER) that are paid out of a fund's assets and thus indirectly by an investor via a reduced unit price each year of his/her investment.

This distinction is also the reason why the appropriate way of assessing the impact of fees on performance is to look at the TER. Initial charges do not impact on fund performance, they impact directly on an investor before his/her money is invested in a fund.

In particular this matters for the growing number of investors that do not pay the full initial charge (which would be used in the combined charge calculation).

Long Term investment

Projections over 1, 3, 5 and 10 years do not help investors to view collective funds as longer term investment products (i.e. predominance of shorter time periods). For consumers investing over a longer period, too much emphasis may therefore be placed on the one-off charge. Longer time periods would be useful to encourage such investors.

Of course, those investing over these short periods are likely to find a table presenting these results helpful. At the same time, encouraging disclosure of charges over shorter time periods just because this is what investors currently tend to do - even though an equity fund investment is designed as a longer term investment - is surely a case of simply “following the herd”.

Also, two funds can have the same combined **one-off** and **ongoing** figure over the specified time period, yet have totally different fee structures. As a result, reliance on such a combined figure will not help improve investors' understanding of charges.

In the same way, it would be possible for a company to change both their **one-off** and **ongoing** charges and still maintain the same combined figure. This cannot be helpful for the industry: it would surely be better to know whether a charging structure is more advantageous for an investor over the shorter or longer term.

Product Comparisons

Using a combined figure to compare collective, life and pension products would seem to be the key argument for disclosing such a figure. However, the question should be asked as to whether investors do and/or should compare charges between life products and collective funds (UCITS).

Competition

To suggest that not disclosing a combined figure could “weaken competition” (FSA Consultation Paper 04/18) again implicitly criticises an **ongoing** charge figure (TER) for not including **one-off** charges (initial/exit charges). As before, the TER does not replace the need for disclosure of **one-off** charges. It does improve disclosure of **ongoing** annual charges.

At the same time, any references to the weakening of competition – and its effect on raising or lowering charges – can surely only be made if evidence for current trends in **one-off** and **ongoing** charges is also provided.

In addition, the question should be asked as to whether less transparency (i.e. what proportion of the combined figure is from **ongoing** fund expenses or from **one-off** investor-specific charges) can strengthen competition?

Dishonest or Misleading?

Any criticisms that a TER is “dishonest” for understating the effect of charges is fundamentally wrong as it presumes that the TER claims to include **one-off** and **ongoing** charges. The TER makes no such claim and to suggest otherwise is itself dishonest.

In the same way, the accusation that “by using historic figures TER can also be misleading” (FSA Note on Charges Disclosure) is flawed as the same “misleading” accusation can be levelled at a combined return reduction figure.

In reality, the TER is far more robust than performance data as a predictive figure. As a TER cannot be calculated for new or recently launched funds (indeed Lipper Fitzrovia requires 90 days of accounting data) then subsequent comments about the level of charges for new funds are largely irrelevant.

If a fund company does not keep operating expenses at an acceptable level in a fund’s early life, then it is legitimate to disclose this. More misleading would be to disclose a predicted figure that may never become a reality if predicted assets do not flow into a fund.

Final Thoughts

Disclosure of charges should surely try and address both why charges matter and how they impact on an investor. A combined figure uses assumptions to address the former, while separate **ongoing** (TER) and **one-off** (initial/exit) figures are vital for the latter.

At the same time, advocates of the benefits of UCITS for retail investors should not be shy in trumpeting the transparency of charges relative to some other financial products.

Transparent information for investors and robust fund governance are essential to ensure the fair treatment of investors, and trying to square the circle of a “catch all” fund charges figure should not be seen as a replacement for these.

Ed Moisson

Lipper Fitzrovia

April 2007