

Response to CESR Consultation Paper on Content and Form of Key Investor Information Disclosures for UCITS

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Since 2004, Lipper has included the expertise and data of Fitzrovia International, whose fees and expenses research is unrivalled globally and recognised as the European industry standard. This knowledge has assisted the European Commission's Simplified Prospectus Workshop and its UCITS Contact Committee, as well as IOSCO's Investment Management Committee and TER Working Groups at both ALFI and INREV.

We are grateful for this opportunity to comment on the Consultation Paper and will focus our comments on one specific area of expertise: fund charges (Chapter 8).

We continue to be supportive of the European Commission's recommendation to disclose current and historic TERs in the UCITS Simplified Prospectus/Key Investor Information (KII), reflecting the industry's moves for greater transparency in this area.

Questions: Chapter 8.

38. Has CESR identified the best overall options for including information about charges in the KII?

Option A and Option B provide two reasonable approaches for clear and simple disclosure in limited available space in the KII.

39. Should a 'consolidated' charges disclosure be included, and how should it be described?

It is important to note that a figure combining one-off and ongoing charges has a different objective from presenting two separate figures. The former tries to make it clearer to investors why charges matter - for the same reason this measure is also presented in absolute amounts (e.g. euros), rather than as a percentage.

In contrast, the disclosure of separate figures focuses on which charges are applied (or may be applied).

Part of the problem in deciding on appropriate disclosure reflects the fact that charges for a fund cannot be presented as simply as other products, such as a loaf of bread.

With this in mind, while disclosure requirements should try to make it as easy as possible for investors to understand charges, there will be an inevitable limit to matching simplicity with accuracy. For example, the initial charge quoted by a product provider will often not reflect the lower charge actually paid by the investor. Similarly, if a period of years is used in the projection for a combined charge, how will this number be agreed upon?

A projected combined charge figure will include ex-ante annual charges, it might impact investors' views on how long they should hold a fund, and it will have difficulties including the variable impact of any performance-related fees that may be in place.

Finally, in the UK a combined figure (Reduction in Yield) was also introduced to enable easier comparisons between financial products (i.e. pensions, investment bonds and collective funds). This objective might not match that for UCITS-specific regulation.

40. Should options for the disclosure of charges in cash terms be explored further?

If part of the role of the KII is to assist investors in understanding why charges matter then the disclosure of a combined figure in absolute amounts would certainly be helpful in "bringing to life" the impact charges have on an investment.

It is interesting to note that the US financial regulator, the Securities & Exchange Commission (SEC), has recently proposed a new summary disclosure of information for investors that includes presenting the impact of charges in a hypothetical scenario in absolute (US Dollar) terms (Release No. 33-8861).

With the US in mind, it is worth adding that many years of TER disclosure has resulted in strong investor awareness. In an Investment Company Institute (ICI) Survey in May 2006, 74% considered a fund's fees and expenses before investing in a fund - the highest proportion selecting any given item of information.

41. Do you have any comments on how charges should be organised (e.g. between charges relating to subscribing and redeeming units, ongoing fund charges, and contingent charges), labelled (e.g. 'initial charges,' 'exit charges,' 'ongoing charges') and the accompanying narrative messages regarding what they include or exclude? How much detail is necessary in a document like the KII?

The division of types of charges presented within Options A and B look clear and sensible.

Presenting the TER as an ex-post figure reflecting annual operating expenses is well-established in the industry. For recently launched funds, a statement to this effect should be made and the TER flagged as an estimate until a formal ex-post calculation can be made.

Performance fees are unlikely to be explained in sufficient detail within the limited space available of a KII and so a reference to these details in the main prospectus should certainly be made. While outside the scope of the current consultation paper, guidelines on the clear and consistent explanation of performance fees would also be useful for investors and, when looking across Europe as a whole, is currently lacking.

42. In relation to the handling of ex-post and ex-ante figures, is it appropriate to include only a single figure for ongoing fund charges in the KII, and if so, on what basis? Do stakeholders have any particular views as to the handling of such information?

If a breakdown of ongoing charges is to be presented beyond the TER, then it is essential that the definition of what is included in different fee items is assessed. A quoted “management fee” in one jurisdiction is very different from that quoted in another - thus one of the benefits of a consistent TER calculation.

Of course, if regulators wish to ensure that the “management fee” is a pure investment advisory fee, then this would be interesting to explore, but is currently exceptionally rare in Europe.

For reference, our fourteen 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
 - Transfer Agency and Shareholder Servicing
 - 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)
-) Together these two categories
) cover Administration

We provided this list to the European Commission’s Simplified Prospectus Workshop in July 2006 and it is broadly in line with that detailed in Annex 1 of the EC’s 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. Such disclosure is probably more appropriate within funds’ reports and accounts.

43. How should situations where there is a material change in charging levels be addressed?

As with other aspects, the limited space available would suggest that a single ongoing charge figure remains most appropriate. Recent changes to management fees - and the resulting estimated impact on the next ex-post TER - can and should be footnoted under the charges table.

As recommended by the European Commission’s paper on the Simplified Prospectus, a reference to historic TERs over time should be useful for investors. These figures may be more appropriately presented within the main prospectus, but a reference in the KII as to where these can be found would be helpful.

The KII should be regularly updated and the date shown clearly on this document.

44. Should portfolio transaction charges be included or excluded from the disclosure of ongoing fund charges? If they should be included, how should assets for which transaction charges are not readily available be handled?

Dropping disclosure of Portfolio Turnover (PTR) while possibly including portfolio transaction costs seems to be confused. Will investors understand the latter yet not understand the former?

It seems to have been decided within a short time period that investors do not understand portfolio turnover. We would suggest that lack of investor comprehension is partly a reflection of the complicated and unintuitive calculation methodology that has been used by the European Commission. We continue to believe that a simpler PTR disclosure would be helpful for investors as a reasonable guide to the degree of active management in a fund (for example, this has proved its worth in the US) - see note below.

For more details on portfolio transaction costs we would refer to the TER Report from the Working Group of ALFI (Association Luxembourgeoise des Fonds d'Investissement), which is the official representative body for the Luxembourg investment fund industry, and with whom we have worked in trying to explain a consistent approach to calculating TERs.

At the least, a reference to the existence of portfolio transaction costs outside the TER should be helpful for investors.

Note on Portfolio Turnover

Having referred to portfolio turnover above, it is worth looking more closely at the current methodology. This is defined in the European Commission 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 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'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 are not better served as a result.

45. Has CESR identified the best option for handling performance fees in the KII?

As noted above, performance fees are unlikely to be explained in sufficient detail within the limited space available of a KII and so a reference to these details in the main prospectus should certainly be made.

Within the KII, disclosure of the presence of a performance fee structure should be made, and a brief statement of this structure (therefore on an ex-ante basis). If performance fees are included in the ex-post TER, then they must also be shown separately, or else the meaningfulness of the TER as a presentation of ongoing charges will be lost.

The implications, and added complications, for a combined charge figure including performance fees must also be borne in mind.

46. Do you agree that CESR should recommend that charges are disclosed on a maximum basis?

Currently initial (and exit) charges are most easily presented at a maximum level. However, as mentioned earlier, this may well not be the level actually paid by investors.

The presentation of maximum annual fees may also be helpful in particular for distribution fees, where current disclosure is focused more on the distributor than the fund company. (For example, while for the vast majority of funds in Europe annual distribution fees are not disclosed in the reports and accounts, but form part of the management fee, in the US an equivalent "12b-1" fee must be disclosed).

Of course, as share classes increasingly reflect different distribution channel or region fee structures, then a KII that is specific to that share class may make this easier to present appropriately.

It is relevant to note that Financial Services Authority (FSA) dropped the requirement to show a maximum management fee as this was "often at such a high level as to be ineffective as a control or provide meaningful information for investors." (PS 04/7 2004)

47. Are there any options for providing more accurate information, in a way which consumers might understand, about charges under different distribution arrangements?

Please see answer to 46 above. At the very least, the KII should be share class specific. In addition, it is certainly possible that if several options are open to a retail investor, with different fee structures, then these could be included in the KII.

48. Do you agree that CESR should recommend that charges for a feeder fund and its master be combined into a single disclosure in the KII?

If such structures are applicable for UCITS, then yes this would be sensible.

Final Comments

The TER provides an 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 alone.

Such disclosure (as well as that of a reasonably calculated portfolio turnover ratio) should be given time to prove its worth. This will be helpful in at least three aspects:

- 1) to create a more level playing field to compare annual fund charges around Europe,
- 2) to increase investor awareness of fund charges, and
- 3) to encourage fund companies, and their fiduciaries, to justify the fund charges that their investors bear.

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