COMMITTEE OF EUROPEAN SECURITIES REGULATORS

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**CONSULTATION PAPER**

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

**Deadline for contributions:** CESR invites responses to this consultation paper by **10 September 2009**. All contributions should be submitted online via CESR's website under the heading 'Consultations' at www.cesr.eu. All contributions received will be published following the close of the consultation, unless the respondent requests their submission to be confidential.

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## Introduction and Executive Summary

**Background**

1. In March 2007, the European Commission set out its proposals for a series of targeted enhancements to the UCITS Directive. One of these proposals was to replace the Simplified Prospectus (SP) for UCITS with Key Investor Information (KII) disclosures. The KII is intended to be a concise and focused presentation of the information that it is important for a prospective investor in a UCITS fund to have, covering largely the same general areas as the SP.

2. The SP, the concept of which was introduced by the UCITS Management Directive (2001/107/EC) in 2002, is widely seen as having failed to achieve its objectives. In particular, there is considered to be a continuing lack of transparency about UCITS, especially their costs and risks; the information given in the SP is not easily understood and used by the average retail investor; the SP is too lengthy and technical; its production is costly and time-consuming; SPs often exceed the Directive requirements; their content is not consistent in all Member States; and they do not assist comparisons between funds, particularly when cross-border sales are involved.

3. Since the Commission published its proposals for enhancements to the UCITS Directive, the legislative process has progressed and the recast Directive was formally adopted by the Council on 22 June 2009. Articles 78 to 82 of that version contain the provisions on KII. In particular, Article 78(2) states:

   *Key investor information shall include appropriate product information about the essential characteristics of the UCITS concerned, which is to be provided to investors so that they are reasonably able to understand the nature and the risks of the investment product that is being offered to them and, consequently, to take investment decisions on an informed basis.*

4. The Level 1 provisions will be supplemented by implementing measures at Level 2, the precise scope of which is set out in Article 78(7). The implementing measures are to cover the detailed and exhaustive content of the KII to be provided to investors and the specific details of the form and presentation of that information. The Commission first sought CESR's technical advice on the aforementioned implementing measures via a request for assistance in April 2007; this was followed by a further request for assistance received in February 2009 (see paragraph 13 below).

   CESR's work on the KID

5. Since the Commission requested CESR's assistance on developing KII disclosures in April 2007, CESR has been working intensively to prepare its response, in parallel with the finalisation of the revised UCITS Directive at Level 1. A sub-group of CESR's Expert Group on Investment Management (IMEG), which is chaired by Mr Lamberto Cardia, Chairman of the Italian securities regulator, the

Commissione Nazionale per le Società e la Borsa (CONSOB), was formed to consider the detail of KII and to develop a recommendation on CESR's response. This sub-group is jointly chaired by the UK FSA and the French AMF and has included representatives of eight other Member States.

6. The first output of CESR's work was a set of advice that was submitted to the Commission in February 2008 (Ref. CESR/08-087). CESR received a significant amount of feedback to the consultation from external stakeholders, including retail investors' representatives. The Commission used CESR's advice as the basis for the investor testing exercise it carried out from March 2008 to May 2009. CESR was closely involved in both the design and roll-out of the testing process, as well as the analysis and interpretation of results.

7. Some of the key recommendations set out in CESR's advice in February 2008 included:

- The document containing the KII should be referred to as the Key Information Document or 'KID'.
- The length of the KID should be limited to two sides of A4 for all UCITS.
- The description of the strategy and objectives of the fund should be combined in a single section of the document and written in plain language.
- Two options for risk and reward disclosure should be tested: i) an improved version of the purely narrative approach and ii) a synthetic risk and reward indicator (SRRI) accompanied by a narrative explanation.
- Past performance information should be presented in a bar chart, using percentages and covering a period of up to 10 years.
- Performance scenarios should take the place of past performance data for funds which have no past performance and for which a proxy cannot be used (typically structured funds); testing should give feedback on which approaches to develop further.
- On charges, testing should assess the merits of disclosure using percentages versus cash figures.

<u>Consumer testing</u>

8. As noted above, the Commission used the advice submitted by CESR in February 2008 as the basis for the testing exercise it subsequently carried out. Seven Member States were covered by the testing: Ireland, Spain, Germany, Sweden, Italy, Hungary and Poland. The testing was split into two phases: in the first phase, investors were asked to compare individual sections of the KID (e.g. the past performance or charges sections) and answer a series of questions; in the second phase, investors saw two different versions of a full 'mock-up' of the KID. The testing also covered a selection of intermediaries in each country with a view to getting reaction from advisers who would be using the new document with real-life investors.

9. The testing has been a very valuable exercise to which CESR has paid careful attention when developing its advice. References to specific findings are included in the relevant sections of this consultation paper. The full report of the contractor that carried out the testing on behalf of the Commission will be made public shortly.[1]

10. CESR notes that the testing exercise brought to light the difficulties many retail investors have when interpreting financial disclosures, even when that information is presented in a relatively clear and accessible way. On that basis, it is important to bear in mind other elements that are needed to allow investors to make informed investment decisions, including good-quality advice (in the case of an intermediated sale) and improved levels of financial literacy. CESR is of the view that the KID represents a considerable enhancement of disclosures for UCITS but recognises the fact that it will not, on its own, solve the problem of informed decision-making by retail investors.

Technical work

11. In the February 2008 advice, CESR identified a number of technical issues arising from its work that merited further consideration. The issues identified fell under three of the broad disclosure headings which make up the KID: i) risk and reward; ii) past performance and iii) charges. The work was to cover a wide spectrum of issues, ranging from development of a harmonised calculation methodology for an SRRI to treatment of past performance information for years in which the fund did not exist.

12. CESR established three separate technical working groups to analyse these issues in more detail. A selection of external stakeholders agreed to join the groups in order to provide additional expertise and a broader perspective. As with the work on the advice delivered in February 2008, the drafting groups prepared a set of recommendations for CESR's Expert Group on Investment Management.

13. In light of the recommendation prepared by the groups, CESR published a consultation paper (Ref. CESR/ 09-047) in March 2009 in which views were sought on these technical issues. CESR received 41 responses to the consultation[2]. The views expressed have been taken into account in the preparation of the draft advice and are referred to in the relevant sections of this document.

Provisional request for assistance

14. As noted above, CESR's early work on the KID was based on the initial request for assistance received in April 2007, which was itself based on the Commission's initial orientations on amendments to the UCITS Directive of March 2007. Once political agreement was reached between the European Parliament and the Council on a compromise text of the new Directive, the Commission prepared a new provisional request for assistance that reflected the latest draft of the

[1] The report will be available via the following link: http://ec.europa.eu/internal_market/investment/investor_information_en.htm

[2] The responses are available here: http://www.cesr.eu/index.php?page=responses&id=134

legislation, including the revised provisions on KII. CESR has worked on the basis of the latest legislative position in developing the advice on which this consultation seeks feedback. The provisional request sets a deadline of 30 October 2009 for the submission of CESR's advice on KII.

**Areas covered by this Paper**

15. Throughout this document, reference is made to the powers and duties of the management company of the UCITS. For UCITS which are investment companies and do not have a designated management company, all such references should be read as applying to the investment company itself.

Format and presentation

16. The introduction of the KID is designed to bring about a step change in the quality of UCITS disclosures compared to the Simplified Prospectus. With a view to facilitating such a change, CESR sets out a number of proposals on the format of the KID, the use of plain language and the length of the document.

Objectives and investment policy

17. CESR proposes that the KID should describe the objectives and investment policy of each UCITS in plain terms, not necessarily repeating the description in its prospectus. It is proposed to add a statement that investors may redeem their units on request, since the consumer testing exercise showed that a significant number of investors failed to understand this essential feature of all UCITS.

Risk and reward

18. The consultation paper sets out two options for risk and reward disclosure: an improved version of the narrative approach versus a synthetic risk and reward indicator (SRRI) supported by a narrative explanation. A large majority of CESR Members consider that an SRRI accompanied by a narrative text should be preferred to the purely narrative approach taking into account a range of factors, in particular in terms of improved comparability of funds. Therefore, this should be seen as CESR's preferred option. These two options were included in the consumer testing exercise. In addition, feedback from external stakeholders on a volatility-based methodology to support the SRRI was sought via the technical consultation. Responses were split between those who were against the notion of an SRRI in principle; those who were not against the SRRI per se but felt the proposed methodology was not appropriate or could be improved; and those that were in favour of an SRRI and the proposed methodology.

19. CESR recognises it is not possible to consult on the question of whether the SRRI should be used without also presenting the details of the proposed underlying methodology. CESR therefore seeks views on both. Most of the detail of the methodology to support the SRRI is set out in Annex 1. It has been amended in light of the feedback received to the March 2009 consultation paper. The key change is the introduction of a VaR-based element for the computation of volatility relevant for structured and other comparable funds. CESR is carrying out further work on the detail of this revised methodology in order to finalise and refine it for the current consultation. The outcome of that work will be published

for consultation as an addendum to this paper later this month, so that interested parties will be able to consider both the principles of the proposal and the complete methodology for delivering it and provide their comprehensive responses by the end of the consultation period. CESR recognises the fact that the consultation period for the elements of the methodology set out in the addendum will be slightly shorter than for the document as a whole.

20. Regarding the enhanced narrative approach, a list of criteria that the narrative should satisfy is set out in Box 5A.

<u>Charges</u>

21. CESR has considered a range of options for charges disclosures during its work on the KID. The approach proposed in this paper consists of a table setting out clearly the different elements of the charging structure (in percentage terms), accompanied by a simple summary measure of charges presented in narrative terms and including a cash figure. For the purposes of the table, the paper makes specific proposals in relation to entry and exit charges, ongoing charges and contingent charges. The inclusion of the summary measure of charges is designed to recognise the preference among investors for the use of cash figures.

22. The paper also sets out proposals on the handling of new funds, material changes to the charging structure and keeping the charges information in the KID up to date.

<u>Performance presentation</u>

23. CESR's proposed approach to presentation of past performance is based on use of a bar chart displaying up to ten years' performance, where available. In addition, CESR proposes to allow performance information to be displayed only where at least one calendar year's data is available. There are also specific requirements on how to calculate the past performance information.

24. Other issues covered under this heading include the annual revision of the past performance record, handling of material changes and inclusion of a benchmark.

<u>Practical information</u>

25. The consultation paper sets out CESR's view on what should be covered in the Practical Information section. The amount of information to be included has been reduced taking into account the results of the investor testing, which showed that consumers tend not to use this section of the document, while respecting the minimum requirements set out in the Level 1 Directive.

<u>Circumstances in which the KID should be revised</u>

26. The Level 1 UCITS Directive obliges UCITS management companies to keep the essential elements of the KID up to date. CESR's proposals in this area aim to clarify what should be taken into account in deciding whether and when a revision is needed.

<u>Special cases – how the KID might be adapted for particular fund structures</u>

27. Taking into account the wide range of structures that exist in the UCITS sphere, CESR has identified a number of situations in which a bespoke approach to the content of the KID might be necessary. CESR's input in relation to these structures is also explicitly requested in the provisional request for assistance of February 2009, which itself reflects the Level 1 Directive text. The proposals CESR makes are designed to ensure that investors are provided with an appropriate level of information for all UCITS, regardless of the structure.

28. In this context, CESR has considered the content of the KID for structured, capital-protected and other comparable UCITS. The particular challenge of these funds is that the display of past performance information is generally not appropriate, given the limited subscription periods associated with these funds. As an alternative, CESR proposes the inclusion of performance scenarios in the objectives and investment policy section of the KID. These scenarios are designed to illustrate the potential performance of the fund under a range of market conditions. Two options are proposed: prospective scenarios using tables or graphs, and probability tables. As a clear majority of CESR Members favour the use of prospective scenarios, this should be seen as CESR's favoured approach.

Other issues

29. The provisional request for assistance referred to in paragraph 13 also invited CESR to give advice on implementing measures that might be adopted under Articles 75(4) and 81(2) of the revised UCITS Directive. Those articles permit the Commission to define the specific conditions that need to be met when providing key investor information and the prospectus in a durable medium other than paper. CESR has taken account of responses to the call for evidence [ref. CESR/09-179] and now proposes measures based closely on the equivalent provisions in the MiFID and DMD. In this section, there is also consideration of topics that could be covered at Level 3.

Costs and benefits

30. This consultation paper identifies the options available for the different elements of the KID. It provides a detailed description of the different policy options and describes their potential positive and negative effects. This is consistent with steps 3 and 4 of the 3L3 Impact Assessment Guidelines.[3] In formulating its final advice, CESR will take into account the results of the work being done by the Commission to assess the likely costs of implementing the KID proposals.

**Areas not covered by this Paper**

Applicability to other products

31. The Commission's original request for assistance of April 2007 noted that the outcome of the work on KII could be seen as a benchmark for disclosures for other investment products. The potential use of the KID as a benchmark was also noted in the Commission's Communication on Packaged Retail Investment Products, published in April 2009, although it was made clear that the content of

[3] http://www.cesr.eu/index.php?docid=5043

the KII would need to be adjusted to reflect the particular features and legal forms of other products. Throughout its work on developing the format and content of the KID, CESR has focused its attention on developing appropriate disclosures for UCITS and has not considered the potential impact on other products. CESR will monitor closely the further developments flowing from the Commission's Communication.

Delivery to investors

32. In the February 2008 advice, CESR made reference to the interaction between the Markets in Financial Instruments Directive and the UCITS Directive in relation to provision of the KID to investors. In particular, it was noted that delivery of the SP to the investor would allow the distributor to satisfy its obligations under MiFID to disclose information on the investment strategy, risks and charges of the UCITS; but that MiFID did not require that information to be disclosed under the specific format of the KID. CESR notes that this potential gap in the requirements has been filled via Article 80 of the recast UCITS Directive, which imposes an obligation on both UCITS management companies and intermediaries to provide the KII to investors in the case of a direct sale.

**Next steps**

33. This consultation will close on 10 September 2009. An open hearing will be organised to discuss the issues raised in the consultation, full details of which will be available on CESR's website in due course. In light of responses received, CESR will formulate its final advice and submit it to the Commission by the end of October 2009.

34. All contributions to the consultation can be submitted online via CESR's website (www.cesr.eu) under the heading 'Consultations' by 10 September 2009.

**Form and presentation of Key Investor Information**

**Section 1: Title of document, order of contents and headings**

Extract from the level 1 text

*Article 78(1): "Member States shall require that an investment company and, for each of the common funds it manages, a management company draw up a short document containing key information for investors. This document shall be referred to as "key investor information" in this Directive. The words "key investor information" should be clearly mentioned in that document, in the language referred to in article 94(1)(b)."*

*Article 78(3); "Key investor information shall provide information on the following essential elements in respect of the UCITS concerned:*

*(a) identification of the UCITS;*

Extract from the Mandate of the Commission

*"CESR is invited to advise the Commission on the following questions: To what extent and in what way should level 2 measures harmonise the detailed presentation of key investor information (such as the layout of the document, its length, headings to be used for sections, etc.)?"*

**Level 2 advice** **Box 1**

The key investor information for each UCITS shall consist of the sections set out below, and shall present those sections in the following order.

1. Title
The title of the document shall be 'Key Information Document', translated as appropriate. This title shall appear prominently at the top of the first page of the document.

2. Explanatory statement
Immediately underneath the title, the following statement shall appear:

'This document provides you with key investor information about this fund. This information is required by law. You are advised to read it before deciding whether to invest.'

3. Name of UCITS
The name of the UCITS, or the investment compartment thereof, shall be stated prominently.

4. Name of management company
For a UCITS which has a management company, the name of the management company shall be stated. If the management company forms part of a group of companies for legal, administrative or marketing purposes, the name of that group should be stated. The KID may include corporate branding provided it is unobtrusive.

5. Objectives and investment policy
A section entitled 'Objectives and investment policy', containing the information set out in section 4 below.

6. Risk and reward profile
A section entitled 'Risk and reward profile', containing the information set out in section 5 below.

7. Charges
A section entitled 'Charges for this fund', containing the information set out in section 6 below.

8. Past performance
Except where indicated in section 14, a section entitled 'Past performance', containing the information set out in section 7 below.

9. Practical information
A section entitled 'Practical information', containing the information set out in section 8 below.

10. Authorisation details
A statement that 'This fund is authorised in [name of Member State] and regulated by [identity of competent authority]'. Where the UCITS is managed by a management company exercising rights under Article 16, an additional statement shall be included that '[name of management company] is authorised in [name of Member State] and regulated by [identity of competent authority].

11. Date of publication
A statement that 'This Key Information Document was published on [date]'. The day, month and year of publication shall be indicated.

12. Identification by code number
At the option of the management company, a code number identifying the UCITS or investment compartment or share class thereof may be included at the foot of the document. The requirements relating to size and clarity of text in section 2 do not apply to this item.

Explanatory text

CESR considers that it is necessary for all KIDs to consist of the same contents and for there to be a common running order and consistent headings, to aid comparability. The order proposed takes account of responses to the consumer testing in which investors indicated which parts of the document they regard as most and least important.

For point 3, where the KID describes an investment compartment, in addition to the name of the compartment in the document title, the name of the UCITS should appear in the 'Practical Information' section of the document. Collectively, these pieces of information fulfil the Directive requirement to identify the UCITS.

For point 4, the purpose of identifying the group to which the management company belongs is to enable investors to know whether the management company is independent or is linked to other entities with which they may be more familiar. The use of corporate branding is commented on in section 2.

For point 9, the consumer testing exercise tested examples of KIDs in which this section was titled 'Additional information'. The testing revealed that many consumers felt the word 'additional' created the impression that it was not key information and could be ignored. CESR has considered various alternatives and has decided that 'Practical information' is likely to be the most helpful title for investors, but would welcome other suggestions.

For point 10, the competent authority may be identified either by its name in the official language (or one of the official languages) of its Home State, or by a translation of that name, or by some other unambiguous designation such as 'the [name of Member State] financial regulator'.

For point 12, the International Securities Identification Number (ISIN), or some other code or number with a similar purpose, may be included if the management company considers it would be helpful to distributors and institutional investors. Since it is of little or no relevance to the average retail investor, it can be added in small print and in an inconspicuous position.

**Questions for the CESR consultation**

*Do you agree with the proposals in Box 1?*

*Should the information referred to in point 9 of the box be called 'Practical information'?*

**Section 2: Appearance, use of plain language and document length.**

Extract from the level 1 text

*Article 78(5): "Key investor information shall be written in a concise manner and in non-technical language. It shall be drawn up in a common format, allowing for comparison, and shall be presented in a way that is likely to be understood by retail investors".*

Extract from the Mandate of the Commission

*"Article 78(5) of the new UCITS Directive imposes additional challenges requiring KII to be written in a brief manner, in non-technical language, drawn up in a common format,*

*allowing for comparison. Information should be presented in a way likely to be understood by retail investors. The aim is to ensure that KII is consistently and effectively produced by different fund managers across different jurisdictions by harmonising the standard or quality of these documents. CESR is therefore encouraged to reflect on possible ways to assist the KII producers in practically observing these rules. The Commission considers this to be a very important aspect in ensuring the effectiveness of the KII proposals.*"

**Level 2 advice** **Box 2**

1. A Key Information Document (KID) should be:

- presented and laid out in a way that is easy to read;
- clearly expressed and written in plain language as far as possible;
- focused on the key information the investors need.

Plain language can be defined as communicating in a way that facilitates the audience's understanding. It is clear, succinct and comprehensible and avoids the use of jargon. Technical terms should be used only when absolutely necessary and explained using everyday words.

2. The KID shall not exceed two A4 pages in length (that is the front and back of a single sheet of A4-sized paper).

3. For structured funds, for which scenarios shall be provided, some flexibility is allowed so that the length of the document can be extended but without exceeding three pages.

4. Characters of readable size should be used for every item unless otherwise stated. The type size used should not be less than 8 points.

Explanatory text

Feedback from consultation and consumer testing has shown the difficulty in providing investors with information in common everyday language they can easily understand.

CESR notes that previous attempts to achieve this objective have not generally met with success.

Research indicates that levels of investment knowledge and financial capability are generally very low. This reinforces not only the need for clear and simple disclosures, but also the importance of efforts to enhance investors' ability to understand financial information.

*Presentation and lay-out*

The KID should be presented and laid out in a way that is easy to read, not confusing to investors, easy to understand and engages its readers. It should make good use of white space on every page to ensure this.

Design techniques may be used to improve the extent to which a disclosure document engages retail investors. However, as KID will be designed and presented to investors either from the internet or printed and/or photocopied in black and white, understanding of the contents should not depend on the use of colours.

The design may reflect the corporate branding of the management company or the group to which it belongs, provided it is unobtrusive – for example, a small corporate logo at the head of the document. Any branding that is so large as to distract the reader, or which obscures text (e.g. a 'watermark' logo overlaying text) would not be acceptable.

*Use of plain language*

Plain language should be used to convey information in a way that is likely to be understood by the retail investor. The needs and abilities of the retail investor should be considered to ensure that the content of the information is relevant**,** the organization of the information is logical and the language appropriate.

CESR has considered feedback from the consumer testing which indicated that many investors find it difficult to understand the terminology used in financial services documents, even where firms have made reasonable efforts to eliminate the use of technical terms and jargon. CESR proposes to consider whether further work could be done in the context of Level 3 to provide a common glossary of terms which could be made available to the public. It may be that industry and consumer representatives would be better placed than competent authorities to undertake such an exercise, which would have consumer education as its primary purpose.

*Information should be key to investors' decision-making*

The information presented in the KID should consist only of information that potential investors need to make an informed investment decision. It should avoid containing information that is not relevant to decision-making, such as information related to the sales process.

*Length of the KID*

Feedback from consultation and consumer testing has shown wide support for standardization and reduction in the length of the document.

CESR notes that it might not be easy to sum up the features of some specific, complicated funds within one sheet, but this has to be weighed against clear feedback from consultation and consumer testing that investors are not likely to read documents more than two pages long. In particular, CESR is aware that specific presentation features or disclosure might be necessary for certain ranges of funds with complex risk and reward profiles, such as structured funds, but still considers this should be achievable in a document of no more than three pages.

CESR considers that this recommendation could be supplemented at Level 3, notably as regards the length of the document (for instance to allow other formats equivalent to two sides of A4), and the setting of the type should be considered so as to avoid the inclusion of 'small print'. In any case, CESR considers that size of the type should not be smaller than 10 points, although it may be acceptable to use a point size of 8 or 9, depending on the font chosen.

*Translation*

In order to achieve consistency, CESR has recommended that all headings and statements in the KID follow prescribed wording. To the extent that this prescription is reflected in implementing measures, a translation of each term will be supplied in the official languages of the European Union. CESR recommends that once the implementing measures are published, competent authorities should give further consideration to ensuring that common terms are translated in a harmonised manner, especially where a language is common to two or more Member States.

**Questions for the CESR Consultation**

*Do you agree with the proposals in Box 2?*

*In particular, do you agree that the maximum length of the document and the minimum acceptable point size for type should be prescribed at Level 2?*

*Are there any other rules that should be prescribed in relation to the appearance of the KID?*

**Section 3: Publication with other documents**

It is important that not only the design and presentation of the KID itself, but the context in which it appears, supports the objective of delivering key investor information effectively.

**Level 2 advice** **Box 3**

The KID should be published in a context that enables potential investors to distinguish it from other material. In particular, it should not be presented in a way that is likely to lead investors to consider it less important than other information about the UCITS, its risks and benefits.

Explanatory text

CESR's recommendations for the KID envisage it as a stand-alone document of two (or at most three) pages. However, this does not exclude the possibility that the KID may be attached to, or form an integral part of, another document. This can be allowed provided the KID is sufficiently prominent to ensure that a potential investor is likely to

see it and understand that it contains important information and is not just an item of promotional literature.

CESR notes (see section 10) that it may be acceptable for a UCITS consisting of several investment compartments to provide a single document in which the KID for each compartment is sequentially presented. This principle could be extended in other contexts where it is likely to be helpful to investors to gather the KIDs for a range of funds together in one place. CESR does not, however, support the preparation of lengthy documents containing the KIDs of many different funds, since it is unlikely that the typical investor would look at such a document, or engage with the material it contains. Nor would CESR find acceptable any marketing document in which the KID appeared in an obscure place, such as in the middle pages or as part of the 'small print' of terms and conditions. It should only appear in such a document if it is prominently displayed and signposted.

| **Question for the CESR consultation** |
| --- |
| *Do you agree with the proposals in Box 3?* |

## Content of Key Investor Information

Extract from the level 1 text

*Article 78(7): "The Commission shall adopt implementing measures which define the following:*

*(a) the detailed and exhaustive content of the key investor information to be provided to investors as referred to under paragraphs 2, 3 and 4;"*

Extract from the Mandate of the Commission

*"CESR is invited to advise the Commission on the following questions: What is the KII to contain and how should this be harmonised at level 2? How should level 2 measures fulfil the requirements of the UCITS IV Directive to specify the content and form of KII in a detailed and exhaustive manner such that the document is sufficient for investors to make informed decisions about planned investments? This should be taken to include the methodologies CESR considers necessary for delivering the information disclosures CESR proposes for the KII (e.g. the methodologies for risk, performance and charges disclosures). CESR should be clear as to the requisite degree of harmonisation it considers necessary for these supporting methodologies"*[4]

**Section 4: Objectives and Investment Policy**

Extract from the level 1 text

*"Article 78(3): Key investor information shall provide information on the following essential elements in respect of the UCITS concerned:*

*[.....]*

*(b) a short description of its investment objectives and investment policy;*

[4] In addition, the initial request for assistance on detailed content and form of key investors disclosures for UCITS which have been delievered to CESR by the Commission in March 2007 provided that:

The results of the SP workshops have shown that plain-language narrative description of the key risks identified by management companies is not necessarily effective. This is to ensure that the overall information given contains a balanced representation of the potential benefits and the risks involved.

The requested work should reflect on how risk disclosures can be improved and propose a common EU-wide approach. This should be done in the context of the sales/distribution process taking into account MiFID conduct of business obligations imposed on intermediaries (suitability/appropriateness of the product for the investor).

One possible route could be to develop EU guidelines to ensure that the narrative description clearly and concisely explains the potential consequences of the risks on the performance and capital invested.

This should include the following elements:

- Review and streamlining of the list of risk factors currently detailed in the Recommendation 2004/384/EC in order to ensure that firms highlight the most important factors for their funds.

Possibly, developing a methodology to give an indicator of the risk appetite and/or uses for which a UCITS is suitable.

**Level 2 advice** **Box 4**

1. The section headed ‘Objectives and investment policy’ shall contain the following items:

a) A joint description of the objectives and policy of the UCITS, allowing investors to distinguish between the objectives and the means used to achieve them.

b) The information listed below, provided it is material:

i) the main categories of eligible financial instruments that are the object of investment;

ii) whether the UCITS has a particular target in relation to any industrial, geographic or other market sectors or specific classes of assets, such as investment in financial instruments of emerging countries;

iii) if it is the case that the UCITS invests in bonds, an indication of whether they are corporate or government issues, and any minimum rating requirements;

iv) whether the UCITS’ management style is a pure discretionary choice within the investment universe, or whether it contemplates some reference to a benchmark; if the latter, giving an indication of the degree of freedom available in relation to this benchmark (such as passive, moderate or active) and in particular whether the UCITS has an index tracking objective;

v) if it is the case that the UCITS offers a pre-determined pay-off after a certain term, based on an algorithm applied to market data, then all elements necessary for a correct understanding of the pay-off and the expected performance drivers should be explained in simple terms, (and signposting if necessary that the algorithm details appear in the prospectus);

vi) if it is the case, that the choice of assets within the investment universe is guided by specific criteria such as ‘growth’, ‘value’ or ‘high dividends’;

vii) if it is the case that assets are managed with a specific hedging, leveraging or arbitrage strategy, the expected performance drivers should be explained in simple terms.

c) A statement that the investor may redeem units on demand, qualifying that statement with an indication of the frequency of dealing in units.

d) If it is the case that the UCITS or its management company specifies a minimum recommended term for holding units (either in the fund prospectus or in any marketing document), or that a minimum holding period is an essential element of the investment strategy, a prominent statement in the following terms:

‘Recommendation: this fund may not be appropriate for investors who plan to withdraw their money within [period of time]’.

e) For structured funds, a presentation of [performance scenarios or a probability table] in the form prescribed in section 13.

2. Any material change to the matters covered in this section should be reflected by a prompt revision of the KID.

Explanatory text

The prospectus of each UCITS will contain a full description of the objectives and investment policy of the fund. The purpose of this section of the KID is not simply to reproduce that description. Rather, it should set out in plain and concise language what the fund aims to do and how it will go about achieving that aim. Article 79 makes it clear that a different form of words may be used in the KID providing the resulting description is not inaccurate, misleading or inconsistent with the prospectus.

The section should cover points that may not form part of the description of objectives and policy in the prospectus, but are essential features of the product which a typical investor would wish to know, such as the fact the investment can be redeemed on request, or in some cases that the fund may be unsuitable unless held for a certain length of time.

A clear statement of the objective (e.g. mainly aiming to achieve capital growth or preservation, paying out or re-investing dividends) must be given so that investors can easily see whether or not the fund is likely to be suitable for their needs. The statement should indicate whether the returns can be expected in the form of capital growth, payment of income, or a combination of both.

A description of the investment policy is likely to be more complex, but it should be possible to indicate to the investor at least how the objective is to be achieved, e.g. by exposure to specific markets or instruments, or the application of a specific formula. A description of the investment strategy may be included as well, if the management company considers it is likely to remain in force for a sufficiently long time to be relevant to prospective investors.

Whether or not specific mention is made of an investment strategy, CESR considers that the information given in this section should distinguish between the investment universe an asset manager operates within (paragraphs (1b(i)) to (1b(iii)) above), and their management style, i.e. the way they intend to select particular assets within this universe (paragraphs (1b(iv)) to (1b(vii)) above).

The following paragraphs provide some detail on the substance of the information that should be included in the objectives and investment policy section. The list is not exhaustive and CESR notes these items, and any others identified from the consultation, could be addressed through Level 3 guidelines.

In relation to (1b(i)), only those financial instruments which have a potentially material impact on the fund's performance need be mentioned, rather than all possible eligible instruments.

In relation to (1b(v)), if it is the case that the pre-determined pay-off is available only to those investors who buy units at a certain point and hold them until a certain date, this should be made clear and an explanation given of what happens when investors buy and sell units at other times (e.g. they receive the then current NAV of the units). If a guarantee from an independent third party is offered, its operation should be explained in this section.

In relation to (1b(vii)), the expected performance drivers might be simply explained as (e.g.) 'taking a view on whether asset prices are likely to fall', or 'taking advantage of inefficiencies in market pricing of related financial instruments'. The impact of such strategies on the UCITS' risk and reward profile would be disclosed in the risk and reward section.

In relation to (1c), consumer testing indicated a degree of uncertainty about investors' ability to access their money. It cannot be assumed that the average retail investor is familiar with the essential features of a UCITS such as the ability to redeem units on request, so this should be made clear, reflecting the specific frequency of dealing (daily, weekly, fortnightly etc.).

In relation to (1d), the second phase of the testing exercise indicated that some consumers were confused by a message relating to a suggested minimum holding period, and misunderstood it to mean that they would be unable to redeem their investment before the end of the stated period. CESR suggests that by slightly modifying the wording of the message, and placing it adjacent to a statement about redemption on demand, the purpose of the message should be made clear.

In relation to (1e), see section 13 of this paper which discusses how the possible future returns of structured funds might be presented.

In relation to (2), a change to this section is most likely to occur as a result of a change to the fund rules, instrument of incorporation, or prospectus of the UCITS. Such changes would automatically prompt a corresponding update of the KID (see section 14). There may be other changes, e.g. in relation to investment strategy, which are not reflected in other documents but are material for the purposes of the KID. CESR recommends that any change to the underlying information covered in this section should be regarded as material, and thus requiring a prompt revision of the KID, unless the management company can justify to the competent authority of the UCITS why that is not in fact the case.

**Questions for the CESR consultation**

*Do you agree with the proposals in Box 4?*

*In particular, do you agree that the information shown is comprehensive and provides enough detail to ensure comparability between KIDs?*

*Are there any other matters that should be addressed at Level 2?*

**Section 5: Risk and reward disclosure**

Extract from the level 1 text

Article 78(3):

*'Key investor information shall provide information on the following essential elements in respect of the UCITS concerned:*

*[...]*

*e) risk/reward profile of the investment, including appropriate guidance on and warnings of the risks associated with investments in the relevant UCITS '.*

Extract from the Mandate of the Commission

*'CESR is invited to advise the Commission on the detailed and exhaustive manner of this section of the KII such that the document is sufficient for investors to make informed decisions about planned investments. This should be taken to include the methodologies CESR considers necessary for delivering the information disclosures CESR proposes for the KII. CESR should be clear as to the requisite degree of harmonisation it considers necessary for these supporting methodologies'[5].*

**Options for risk and reward disclosure**

The initial request for assistance from the Commission to CESR explicitly asks CESR to deliver advice on possible ways to improve risk and reward disclosure by ensuring that only relevant risks are mentioned and explained, and to consider whether a synthetic indicator should be required.

In its February 2008 advice on risk and reward disclosure, CESR explored two options:

Option A: to enhance the current purely narrative approach;

Option B: requiring a synthetic indicator with accompanying explanatory text.

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[5] In addition, the initial request for assistance on detailed content and form of key investors disclosures for UCITS which have been delievered to CESR by the Commission in March 2007 provided that:

The results of the SP workshops have shown that plain-language narrative description of the key risks identified by management companies is not necessarily effective. This is to ensure that the overall information given contains a balanced representation of the potential benefits and the risks involved.

The requested work should reflect on how risk disclosures can be improved and propose a common EU-wide approach. This should be done in the context of the sales/distribution process taking into account MiFID conduct of business obligations imposed on intermediaries (suitability/appropriateness of the product for the investor).

One possible route could be to develop EU guidelines to ensure that the narrative description clearly and concisely explains the potential consequences of the risks on the performance and capital invested.

This should include the following elements:

- Review and streamlining of the list of risk factors currently detailed in the Recommendation 2004/384/EC in order to ensure that firms highlight the most important factors for their funds.

Possibly, developing a methodology to give an indicator of the risk appetite and/or uses for which a UCITS is suitable.

Since the publication of that advice, CESR has considered further how a synthetic indicator might work, taking account of the results of the consumer testing and the responses to the technical consultation.

Findings from Phase 1 of the consumer testing exercise revealed that investors seem to be more confident in their ability to compare funds and assess their level of risk when they are provided with the synthetic risk indicator. It appeared also that their real level of understanding was not impacted (neither better nor worse on an overall basis).

Findings from Phase 2 of the consumer testing exercise revealed that in general the number of respondents choosing correct answers for specific true/false statements about risk and reward was similar for documents using the narrative approach and the synthetic indicator which suggests that neither approach is markedly better nor worse at helping investor understanding of risk and reward than the other. However, a much higher proportion achieved correct answers to a large number of statements using the synthetic indicator. As a result the average number of correct responses achieved is higher for the documents using the synthetic risk indicator than for the documents with the purely narrative approach.

Consumers expressed a strong preference for the synthetic indicator over the purely narrative approach. Respondents liked the visual nature of the indicator, which is less intimidating than the narrative alternative, and said that it made the risk profile easier to understand, especially for non-experienced investors. In particular, there are indications that it does improve understanding of the risk and reward profile (over a narrative variant), particularly for funds at the high and low ends of the risk scale. Some respondents mentioned that the indicator could be improved by more detail on the fund, in particular why the fund was in a certain category, in the accompanying explanation (along the lines of the narrative description).

CESR's analysis of the advantages and drawbacks of both options is presented below, followed by advice on Level 2 measures for each option.

**Advantages and drawbacks of the two approaches to risk and reward disclosure**

***Advantages of enhanced narrative approach***

- No methodological issues.
- Enables firms to reflect more accurately the potential complexity of the fund's risk profile.
- Low implementation costs for firms.

***Disadvantages of enhanced narrative approach***

- Description of risk not harmonised across Member States. However, guiding principles should be defined at Level 2 to foster harmonised approach.
- May result in long lists of risk that are not useful to investors and

which may impede engagement with the document. However, the KID will be limited to 2 pages, it shall cover the main risks only and the liability would be limited to certain specific circumstances.

- Does not foster easy comparability across funds.
- Principles might not succeed in giving clear messages that fully reflect the overall risk and reward profile of the fund. This would raise supervisory challenges.
- Findings from the consumer testing exercise revealed that investors have difficulties understanding technical terms. In particular, the narrative description of risks was ranked as harder to understand than the indicator accompanied by a narrative.
- Moral hazard – if the list of risks communicated by the firm misrepresents the real levels of risk, consumers may hold regulators responsible.

***<u>Advantages of synthetic indicator approach</u>***

- Findings from the consumer testing exercise revealed that investors seem to be more confident in their ability to compare funds when they are provided with the synthetic risk indicator.
- Easy to use as a tool for decision-making.
- Better engagement – Respondents to the consumer testing liked the visual nature of the indicator and

***<u>Disadvantages of synthetic indicator approach</u>***

- Could lead investors to over-rely on a number and underestimate the other risks. However, appropriate wording should be used to avoid consumers being misled about the limits of the information shown.
- Findings from the consumer testing show that some readers may over-estimate the level of 'safety' of a lower category investment. However, an appropriate wording should be added explaining that the

| | |
|---|---|
| said that it made the risk profile easier to understand especially for non-experienced investors. | lowest risk category is exposed to potential losses. |
| • Harmonised presentation of risks which should foster comparability of funds. | • The methodology based on volatility may not cover certain risks. However, the indicator will be accompanied by a narrative description of the risks not covered. |
| • Harmonised methodology for all fund types.<br>• Findings from the consumer testing indicate that the SRRI improves investors' understanding of the risk and reward profile (over a narrative variant), particularly for funds at the high and low ends of the risk scale. | • In the qualitative testing, some consumers mentioned that the indicator could be improved by including more detail on the fund, in particular why the fund was in a certain category, in the accompanying explanation (along the lines of the narrative description).<br>• Possible higher implementation costs (tools might be made available to address this).<br>• Moral hazard – if the methodology misrepresents levels of risk, consumers may hold regulators responsible.<br>• Findings from the consumer testing exercise revealed that investors have difficulties understanding technical terms. This is relevant also to the narrative text that will accompany the indicator. |

A strong majority of CESR Members express a preference for Option B, taking into account the advantages outlined above, including the improved comparability of funds. Therefore, Option B is presented as CESR's preferred approach. However, both options are presented in this consultation. CESR seeks views as to whether it should recommend Option B in its final advice to the Commission instead of Option A.

CESR is aware that in order for respondents to provide their views on their preferred option, further development and refinement of the methodology proposed at Annex 1 is needed. As outlined in paragraph 19 of the Introduction, CESR plans to publish a separate addendum by the end of July setting out the results of this further work. CESR

advises that respondents should consider this further work on the methodology before providing final views on which method of disclosure (Option A or Option B) they prefer.

**Questions for the CESR consultation**

*What are your views on the advantages and disadvantages of each option described above?*

*Do you agree that Option B (a synthetic risk and reward indicator accompanied by a narrative) should be recommended in CESR's final advice? Respondents are invited to take due account of the methodology set out in Annex 1, as supplemented by the addendum to be published by the end of July, when considering their view on this question.*

## Option A: Presentation of the enhanced narrative approach

**Level 2 advice** **Box 5A**

1. The description of risk and reward should be sufficient to enable an investor to understand reasonably well the overall significance and effect of the various risk factors associated with an investment in the UCITS described. In particular, it should:

a) link potential risk and potential reward, and explain that there is a general correlation between the possibility of gains and the possibility of losses;

b) identify and describe the key categories of risk that are relevant to the fund's overall risk profile, such as market risk, credit risk, counterparty risk, liquidity risk, and operational risk;

c) characterise the fund's market risk by conveying the likelihood and potential magnitude of gains and losses, taking account of factors such as the asset types held, the markets in which they are traded, their liquidity, the concentration of the portfolio and the degree of leverage (if any) embedded in them;

d) where a significant level of investment is made in debt securities, characterise the credit risk in terms of the likelihood and potential magnitude of a default by the issuer, taking account of the type of debt security, the priority assigned to holders, and the rating given to it by credit rating agencies;

e) where a significant level of investment is made in financial instruments that are likely to have a relatively low level of liquidity (for example, because they are only traded on a small emerging market), mention what the consequences might be for investors in the fund, taking account of the frequency of opportunities to redeem units;

f) where financial techniques such as derivative contracts are used to obtain, increase or reduce exposure to underlying assets, explain their likely impact on the fund's risk profile (without necessarily attempting to describe in detail how they function);

g) where a fund is backed by a guarantee from a third party, or where its investment exposure is obtained to a material degree through one or more contracts with a counterparty, give an explanation of counterparty risk.

2. The description should be limited in size, both in terms of the amount of space it occupies within the KID and the density of text, and be presented in a way that is likely to engage the attention of the retail investor. It should use plain language, avoiding specialist terms whose meaning the general population is unlikely to be familiar with, so that the description is always focused on the likely outcome for the investor.

3. The description should use narrative text only and should not use a scale or any graphics.

4. A management company should ensure that for the range of UCITS which it manages:

a) the manner of presentation of risk and reward is consistent between each KID that it prepares, and fosters comparability between different products;
b) any description that would enable investors to rank each UCITS relative to others in the range, is not inconsistent with the management company's assessment of the levels of risk presented by those funds, based on its internal process for identifying, measuring and monitoring risk.

5. Any material change to the matters covered in this section should be reflected by a prompt revision of the KID. If the change is the expected result of a decision by the management company, a revised KID should be made available before the change comes into effect.

Explanatory text

In the qualitative phase of consumer testing, reactions to the narrative description of risk were mixed. Some thought the description to be clear (and indeed a few thought it preferable to the synthetic indicator) but there were some misunderstandings and for many, a need for greater clarity.

The proposal for a purely narrative description of risk in the KID recognises that such a description must be complementary to the full description appearing in the fund prospectus. The description in the KID, which is necessarily limited as to the amount of space and number of words that can be used, must focus on the important elements that are likely to distinguish one UCITS from another in terms of their comparative risk.

For almost all funds, market risk and liquidity risk are relevant, so particular attention should be paid to them. For many funds, credit risk or counterparty risk are likely to be equally important. Aspects of operational risk may also have a significant impact on the investment potential of certain funds.

Characterisation of market risk might be done in various ways, and will depend to some extent on each management company's approach to identifying and assessing risk through its internal risk management process. An assessment based on an analysis at instrument level may be precise, but could quickly become out of date if the fund is actively managed or undergoes a portfolio restructuring. A classification which tries to indicate the general level of risk of each asset class comprising the portfolio will be less precise, but probably more stable over time. It may be helpful to investors to express risk in simple qualitative terms such as 'low', 'medium to high' or 'very high', provided there is an underlying framework that enables ongoing monitoring of the risk level of the portfolio in a consistent fashion.

In relation to liquidity risk, any description of such risk must take account of the fact that all UCITS are intended to have a high level of liquidity, in order to meet their obligation to allow redemption on request. The description should nevertheless give some indication of where each UCITS stands in relative terms, so that (for example) an investor can appreciate that a fund investing in short-term money-market instruments or government bonds is likely to be more liquid than one that invests in emerging markets. The significance of this information depends to some extent on the frequency at which units can be redeemed; a fund which offers fortnightly or monthly dealing may be able to hold less liquid instruments than a fund offering daily dealing, without any impairment to the level of liquidity risk which it presents to investors.

In relation to counterparty risk, disclosure should focus on the consequences to the fund if that counterparty should default on its obligations under the contract. Counterparties include groups of related counterparties and entities that are closely linked.

In relation to (2), some examples of the type of terminology that may cause difficulties for the average investor include 'OTC derivative', 'index' or references to specific indices, 'benchmark', 'arbitrage', 'relative price value' and 'protected maturity price'.

In relation to (4a), a possible means of fostering comparability between products might be through reference to a 'risk-free' investment of a type familiar to investors, or by reference to some other asset class or investment product if that is likely to help investors' understanding. Reference to risk-free investment may be particularly suitable or appropriate for structured funds, capital protected or other similar funds.

The reference to relative ranking in (4b) does not imply that management companies must introduce such a ranking. Rather, where they offer descriptions of risk which investors or their advisers could use to construct a 'relative table' of funds in the same range, the firm should ensure that those descriptions have some consistency with the firm's internal modelling. Clearly, the language which firms use in their internal process may be far too complex for an average investor to understand, but firms should at least ensure that where marketing or sales personnel have prepared descriptions of fund risk, the risk management function is given the opportunity to review and comment on those descriptions prior to publication, and to warn senior management if they have expressed concerns that were not promptly addressed.

In relation to (5), it is clearly important that the risk profile of the fund is kept up to date so that any significant change is promptly incorporated into the KID. Such

changes may be inadvertent, in which case the management company must react to them after the event and adjust the KID accordingly. Others may be the deliberate result of the directors or senior management of the UCITS taking a conscious decision to modify its risk profile, in which case the change (if not already covered in the fund rules, instrument of incorporation or prospectus) should not come into effect until a duly revised KID has been prepared and made available.

**Questions for the CESR consultation**

*Do you agree with the proposals for presentation of risk and reward in Box 5A?*

*Are there any other issues that CESR should consider if it decides to recommend this approach to the disclosure of risk and reward?*

**Option B: Presentation of the synthetic risk and reward indicator complemented by narrative explanations**

**Level 2 advice** **Box 5B**

1. Risk and reward disclosure shall take the form of a synthetic indicator supplemented by a narrative description of the main risks relevant to the fund's overall risk profile.

2. The synthetic indicator shall be based on the volatility of the UCITS past performance which will be complemented, where appropriate, by the use of simulated performance. The detailed proposed methodology for the computation of the synthetic risk reward indicator is provided in Annex 1.

3. The synthetic indicator shall be accompanied by a narrative description of the limitations of the indicator. In particular, the narrative description should:
- clarify that the lowest risk category differs to categories where there is no risk at all.
- explain the overall accuracy of the indicator.

4. The synthetic indicator shall take the form of a numerical scale accompanied by brief explanations. Its presentation shall comply with the following requirements:
a) the scale should show a sequence of numbers in ascending order, from left to right, representing the levels of risk and reward, from lowest to highest;
b) it shall made clear on the scale through graphic presentation, for example, the use of arrows, that lower risk entails potentially lower reward and that higher risk entails potentially higher rewards;
c) no colours shall be used, although a grey-scale shading may be used for the box containing the assigned category.

Explanatory text

As noted above, CESR's preferred option is the synthetic risk and reward indicator complemented by a narrative explanation. As the introduction of an indicator would represent a significant change compared to the narrative disclosures currently used in many Simplified Prospectuses, the testing exercise placed a stronger focus on assessing consumers' understanding and interpretation of the indicator.

A particular aspect of the synthetic indicator that was tested was how investors would interpret funds that were classed at the extremes of the scale (i.e. category 1 for the lowest risk category and category 7 for the riskiest category in the mock-ups tested). For category 1 funds the concern was whether investors would mistakenly infer that a lower potential for gains and losses also implied a guarantee that they would not lose money. For category 7 funds the concern was whether the relationship between potentially high rewards and potentially high risk of losing money was recognised by investors. In general, understanding of the implications was good. However, the testing produced some evidence that, although the fact that a category 1 fund is not guarantee not to lose money is well recognised, there is some feeling that it does provide a degree of protection from even the worst market conditions. An additional question designed to assess consumers' understanding of the relationship between the different categories identified some problems of comprehension regarding the non-linear nature of the scale, notwithstanding the indications that understanding of the risk and reward profile is improved as mentioned above.

CESR acknowledged that a common methodology was required to assign a risk category to each UCITS fund. In addition, CESR suggested that one single numeric scale, for all funds if possible, might be appropriate as it would be simple to understand and meaningful for investors (i.e. conveying the meaning of different categories in terms of potential gains or losses).

The synthetic risk and reward indicator shall comply with the following requirements:
a) applicability to as many funds as possible;
b) robust calculation methodology with no room for manipulation;
c) clarity that categorisation does not imply any guarantee;
d) as simple as possible, to be user-friendly and understandable by average investors.
e) easy implementation by UCITS providers;
f) easy and effective supervision by the regulators;
g) stability and robustness of the categorisation against normal changes in the risk of capital markets;

The synthetic risk and reward indicator should be accompanied by a narrative description in order to ensure clarity regarding the limitations of the indicator. In particular, the narrative description should explain:

- that also the lowest risk class is exposed to potential losses:
- that extreme adverse market circumstances may trigger severe losses in all cases;
- the impact on the fund's risk profile of some specific risks (such as credit, counterparty and operational risk) which may not be fully captured by the synthetic risk indicator. This description should fulfil the requirements under

paragraph 1 (from b) to e) and g)) in box 5A (that concerning the enhanced narrative approach),

In the technical consultation in March 2009, CESR sought feedback on its proposal for a methodology based on historical volatility. Feedback to the consultation revealed mixed views, with many contributions pointing out the limits of the proposed methodology. A number of respondents expressed concerns as regards the use of a methodology that would be based on historical (past performance) volatility and would not cover all UCITS categories, notably structured funds. They made some proposals to improve the methodology, in particular that the use of a modifier for UCITS with a more complex risk and reward profile should be discarded, and that a Value-at-Risk (VaR)-based methodology for the computation of volatility would be a more appropriate alternative to historical volatility for structured and guaranteed funds.

CESR has revised the methodology in light of responses to the technical consultation. The new methodology, on which CESR is seeking feedback, is now based (for structured UCITS) on volatility as computed through reverse engineering from a VaR measure. The detailed proposal is set out in Annex 1.

The arguments in favour of the proposed methodology are that:

- it is capable of covering all UCITS types and works for the most sophisticated products
- it is easy for the asset management industry to implement, computationally simple and unambiguous.
- historical volatility is easy for regulators to verify as it is difficult to manipulate abusively.
- in addition, historical volatility, on which the methodology is based, presents many merits as an objective measure of a fund's risk and reward profile.
- the concept is well-known in the asset management and broader financial industry and is easy to grasp.
- it encompasses most of a fund's risk exposures since those exposures contribute to the fluctuations in a fund's NAV.

CESR notes that for some complex and/or structured UCITS, a methodology based on volatility may not capture all risks, such as tail or event risks. This will have to be addressed through appropriate wording that can be understood by investors.

**Questions for the CESR consultation**

*Do you agree with the proposals for presentation of risk and reward in Box 5B? In particular, is the proposed methodology in Annex 1 capable of delivering the envisaged benefits of a synthetic indicator?*

*Does the methodology proposed by CESR work for all funds? If not, please provide concrete examples.*

*Respondents are invited to take account of the methodology set out in Annex 1, as supplemented by the addendum to be published by the end of July, when considering their view on the questions above.*

*Are there any other issues that CESR should consider if it decides to recommend this approach to the disclosure of risk and reward?*

**Section 6: Charges disclosure**

Extract from the level 1 text

*Article 78(3): "Key investor information shall provide information on the following essential elements in respect of the UCITS concerned:*

*[.....]*

*(d) costs and associated charges;"*

**Level 2 advice** **Box 6**

**Presentation of the charges**

1. The charges section of the KID should state that the charges an investor pays are used to pay the costs of running the fund, including the costs of marketing and selling. It should also state that charges reduce the growth of the investment.

2. The charging structure should be shown in a table using the following structure:

| One-off charges taken before or after you invest | |
|---|---|
| **Entry charge**<br>**Exit charge** | [ ]%<br>[ ]% |
| This is the maximum that might be taken out of your money [before it is invested] [before the proceeds of your investment are paid out] | |
| Charges taken from the fund over each year | |
| **Ongoing charge** | [ ]% |
| Charges taken from the fund under certain specific conditions | |
| **Performance fee** | [ ]% a year of any returns the fund achieves above its |

| | benchmark, the [insert name of benchmark] |
|---|---|

A percentage amount should be indicated for each of these charges.

3. In addition to the table showing the amounts of the charges, the KID should include brief narrative explanations of each of the charges, as specified in (a), (b) and (c) below.

*(a) Entry and exit charges.*
The entry charge and exit charge shown should each be the maximum percentage which might be deducted from the investor's capital commitment to the fund. It should be made clear that the investor might pay less. The KID should provide a statement that the investor's financial adviser or distributor can find out what the actual entry and exit charges will be.

*(b) Ongoing charges paid out of the fund's assets each year.*
(i) A single figure representing all annual charges, and other payments taken from the assets of the UCITS on a periodic basis, shall be published. It shall be referred to as the 'ongoing charges figure'. It shall be calculated using the methodology set out in Annex 2.

(ii) There shall be an explanation that
- the ongoing charges figure is based on the last year's expenses and
- (if it is the case) this figure may vary from year to year.

(iii) The ongoing charges figure does not include portfolio transaction costs. Where the impact of these costs on returns is likely to be material due to the strategy adopted by the fund, this should be stated within the Objectives and Investment Policy section. That statement should explain that the portfolio transaction costs are paid by the fund in addition to the charges set out in the charges section.

(iv) The ongoing charges figure should exclude performance fees. Performance fees should be disclosed according to (c) below.

(c) *Contingent charges taken from the fund from time to time, such as performance fees.*
The KID should include a statement which explains when these fees will apply. The performance fee of the fund's last financial year should be included as a percentage figure.

4. All the elements of the charging structure should be presented clearly and as simply as possible to allow investors to consider for themselves the combined impact of the charges.

5. The charges section of the KID should also include a signpost to where the more detailed charges information within the fund prospectus can be found including detailed information on performance fees and how they are calculated.

<u>Explanatory text</u>

CESR's recommendation for the disclosure of charges information is for a table with prescribed headings to be used.

*Entry/exit charges*

Any one-off charges, such as entry and exit fees, should be disclosed. This figure should be the maximum percentage the investor might pay. In cases where funds allow ongoing subscription plans and there is a premature interruption to that subscription plan, a warning should be included to explain that investors may end up paying a higher charge in proportion to the amount of capital actually invested into the fund. As noted in previous consultations, key information disclosures cannot be tailored to individuals and as such, in order to avoid the information from being misleading, the maximum percentage should be shown. The KID should state, in any case, that the investor may in fact pay less than the stated percentage and should provide information about how to find out exactly what the charges will be.

*Methodology for ongoing charges figure*

In its technical consultation, CESR identified three possible options for harmonising the calculation of the ongoing charges figure:

(a) to show the ongoing charges figure based on ex-post figures;
(b) same as option (a), but show additional ex-post data for multiple years alongside or as part of the past performance graph; and
(c) show the ongoing charges through two figures rather than one - an ex-ante estimate and an ex-post figure.

The benefits and drawbacks of each option were discussed. The use of option (a), a single ex-post figure, which offers simplicity of presentation and a single focal point, was strongly supported by CESR and by most respondents to the technical consultation. It is relatively easy to explain and to supervise (using audited fund accounts), relatively easy to apply consistently to funds as an overall measure of funds costs, and it has been strongly supported by the industry, building on the existing TER methodology.

CESR consequently recommends the use of a single ex-post methodology. Although there is the possibility that investors may not understand that the total amount of charges can vary from one year to another, CESR suggests this drawback can be overcome by the use of a warning.

The methodology proposed by CESR for identifying which items should be included in the ongoing charges figure and for harmonising the calculation was agreed by almost all respondents to the technical consultation. The main points to note are that:

- there is a presumption that all costs borne by the fund must be taken into account unless they are explicitly excluded;
- performance-related fees and transaction costs are among the costs excluded from the calculation (as are entry and exit charges borne by the investor);

- an ex-post calculation based on audited accounts should be used wherever possible; and
- adaptation of the methodology is necessary where a new fund is to be launched, or where there is a significant change to the costs of an existing fund.

All respondents to the technical consultation agreed with CESR's proposal to include a warning that ongoing charges may vary from year to year.

*Portfolio transaction costs*

CESR has not developed specific proposals for the detailed disclosure of portfolio transaction costs, for the reasons explained in its March 2009 consultation paper[6]. This analysis was supported by the majority of respondents to the consultation. CESR recommends that where their potential impact on returns is known or considered likely to be material, it should be highlighted through a narrative warning in the Objectives and Investment Policy section.

However, CESR notes that greater clarity and transparency would be desirable in this area. In this regard, further work might be considered with a view to developing an improved disclosure of transaction costs. If a satisfactory solution can be found, an improved disclosure of transaction costs could be incorporated into the KID or related disclosures at a later date.

*Performance fees*

Phase 2 of the consumer testing exercise revealed that performance fees are not well understood, even by experienced investors. Only a quarter of consumers tested realised that performance fees could be the differentiating factor between the charges of two funds. The testing did not reveal any firm conclusions about how to deal with ambiguity surrounding performance fees. On this basis, CESR recommends KID should disclose an ongoing charges figure which excludes performance fees. Those fees should instead be explained clearly and as simply as possible through a narrative description.

A number of issues regarding the details and viability of such an approach were discussed by CESR and alternative options were also explored. There was concern, for example, that investors should be able to use figures provided in the KID as a good guide to future charges, and that in some circumstances ex-post figures would not necessarily be such a good guide.

**Questions for the CESR consultation**

*Do you agree with the proposals in Box 6?*

*In particular, do you agree the table showing charges figures should be in a prescribed format?*

*Do you agree with the methodology for calculating the ongoing charges figure?*

[6] CESR/09-047, Chapter 3, paragraphs 30-34.

**Disclosure of charges in cash terms**

<table><tr><td>

<u>**Level 2 advice**</u> **Box 7**

**Summary measure of charges**

1. The KID should present in narrative terms a summary illustration of the charges, as follows: 'The combined effect of the maximum entry/exit and ongoing charges shown above on an initial investment of €1000, over [x] years, assuming a [x]% growth rate, would be [€xx]. This is not a forecast of what you might get back.'

2. The currency symbol may be adapted to that used in the Member State in which the UCITS is established, or in which it is being promoted on a cross-border basis.

</td></tr></table>

<u>Explanatory text</u>

The consumer testing exercise presented investors with different examples of information on fund charges. In the second phase of testing, investors were presented with:

- a version containing a section called the 'Illustration of the charges' in a text format, expressing charges as a percentage; and
- a version containing the 'Illustration of the charges' in a table format, expressing charges in monetary figures.

The results of the consumer testing revealed that consumers' preferences regarding charges disclosure were mixed. In Phase 1 of testing, investors expressed a clear preference for an 'Illustration of charges' in a table format. They felt it was clear, facilitated comparability and disclosed more information.

Phase 2 of testing demonstrated that, despite consumer preferences in the early testing, the 'Illustration' in table format did not really improve comprehension levels. When comprehension was tested in Phase 2, the version with the 'Illustration' generally proved inferior to the version without it.

However, Phase 2 of testing also revealed that the 'Illustration' was valuable in that it greatly aided investors in estimating the charges they would pay in the years explicitly listed in the table.

The feedback received to the technical consultation from industry participants showed a strong lack of support for a summary measure of charges using cash figures. The main concerns expressed were that a summary measure would be based on too many assumptions, could never be sufficiently accurate, and could mislead investors into thinking the charges presented were absolute and that certain returns were therefore guaranteed.

CESR discussed the possibility of improving the tested 'Illustration' by explicitly including charges for ten years of investment rather than just three selected years. However, it concluded that the arguments advanced in the consultation feedback were

too strong to justify recommending an 'Illustration' or other summary figure of charges in table format, either in the form tested or an enhanced form. However, given that some investors would find a combined charges figure in cash terms helpful, CESR decided that a simple 'Illustration' of the effect of charges, in cash terms, should be provided in narrative form. The method for calculating this figure can be found at Annex 3. In regard to this methodology, CESR has not prescribed a specific growth rate on the basis that doing so would be too problematic for all UCITS and may be misleading.

**Questions for the CESR consultation**

*Do you agree with the proposals in Box 7?*

*In particular, do you agree that CESR should not prescribe a specific growth rate in the methodology for calculating the illustration of the charges?*

**Circumstances in which ex-post figures might be inapplicable**

**Level 2 advice** **Box 8**

**New funds**

1. In the case of new funds, the use of an ex-post calculation of the ongoing charges figure will not be possible and the following procedure should be adopted.

2. For funds which charge a fixed, all-inclusive fee (i.e. where the figure is set at a level expected to cover all charges and expenses, and the management company absorbs any consequent profit or loss), that figure should be displayed.

3. For funds which set a cap or maximum on the amount that can be charged, that figure will be the appropriate one to disclose if the management company gives a commitment to respect the published figure and to absorb any costs that would otherwise cause it to be exceeded.

4. In all other cases, an ex-ante figure shall be estimated, based on the expected total of charges. These estimates shall be fair, clear and not misleading.

Explanatory text

Most respondents to the technical consultation agreed with CESR's proposal for dealing with ongoing charges for new funds.

In determining whether an estimated ex-ante figure is fair, clear and not misleading, the following should be considered:

- Fee payments on an ad valorem basis should either be taken into account on a pure ex-ante basis or an attempt should be made to estimate their likely impact, based on a view of what the fund's average NAV might be over its initial period.

- A more complex variation involves two or more tiers bearing ad valorem fees. This is usually organised so that the first tier attracts the higher fee, with assets in excess of that value paying a lower fee. Where a tiered fee structure is in place, it should be assumed for the purpose of the calculation that the fees applicable to the lowest tier are charged, unless the UCITS operator has valid grounds for believing a higher tier will apply.
- The impact of flat fees on the disclosure figure will require an assumption to be made about the level of the fund's NAV, as discussed below.
- Fees charged per transaction or per account (e.g. shareholder registration fees) should only be taken into consideration if estimates of the likely number of transactions/accounts are made ex-ante. For portfolio transactions, the investment manager should be able to make an estimate based on the fund's investment strategy and target assets. For numbers of accounts, the manager may have experience of similar funds, or its administrator/transfer agent may be able to assist, based on experience with other funds.

During the initial period of a new fund's existence, there is an issue about the extent to which realistic assumptions can be made about the average level of its NAV. There are some situations in which predictions can confidently be made about initial assets under management:

- Where the first property of the new fund is to come from the transfer of assets from another fund (or funds) being wound up.
- Where there is a firm commitment for monies under the control of the operator or its associates to be transferred (e.g. discretionary managed portfolios within the same group).
- Where the operator has a contractual commitment with a third party to manage that party's assets within the new fund (e.g. target fund for a fund of funds).

In each of these cases, it is reasonable for the anticipated level of investment to be used as a basis for estimating an average NAV. If none of them is applicable, the operator or an associate in its group may be willing to commit an amount of seed capital for a certain period. This may also be suitable for estimating the NAV, although it is more open to manipulation (for example, the money might be withdrawn so that the fund would contract in size and incur higher charges than are stated in the KID). If there is to be no seeding, a sensible assumption about the likely level of investment into the fund is required and this should need to be conservative, not just a sales target.

| **Question for the CESR consultation** |
| --- |
| *Do you agree with the proposals in Box 8?* |

| **Level 2 advice** | **Box 9** |
| --- | --- |
| **Material changes to the charging structure** | |

1. The information on charges should properly reflect any change to the charging structure that results in;
a) an increase in the maximum permitted amount of any one-off charge payable directly by the investor;

b) an increase in any charge levied by the management company or its associate that would cause the published ongoing charge figure, if it were to be recalculated using the revised level of charges, to increase by [5]% or more of its current value;

c) any other material change in the charging structure:
i) that would cause the published ongoing charge figure, if it were to be recalculated using the revised level of charges, to increase or decrease by [5]% or more of its current value; or
ii) that would in some other way cause the current disclosure of charges to be unfair, unclear or misleading.

2. The management company shall establish procedures to ensure that the ongoing charges figure disclosed in the KID is reviewed with sufficient frequency to ensure that (1c (i) and (ii)) can be complied with.

3. When (1b) or (1c (i) or (ii)) apply, the management company should estimate an ongoing charge figure that it believes on reasonable grounds will be indicative of the amount likely to be charged to the UCITS in future. This change of basis should be labelled as follows:

'The ongoing fund charge shown here is an estimate of the charges for the next year. [Insert short description of why an estimate is being used rather than an ex-post figure.] The fund's annual report will include detail on the exact charges made.'

4. In the case of (1a) and (1b) above, and where the timing of a change in (1c) is within the control of the management company, the KID reflecting that change shall be published before the revised charge comes into effect. In all other cases, the KID shall be revised as soon as reasonably practicable after the management company becomes (or should have become) aware of the change.

Explanatory text

For a fund where a charge is to be, or has already been, increased, the effect of that charge will not be reflected in ex-post data for some time to come (e.g. in cases when the annual management charge has been altered in the course of the fund's accounting year). If the change is of sufficient magnitude to alter the overall figures materially, the continued use of the ex-post figure might be misleading to investors. An estimated figure should be used instead. The proposed wording was agreed by CESR.

It was agreed by all respondents to the March 2009 technical consultation that a harmonised definition of 'materiality' would ensure better comparability across Member States. CESR received some suggestions as to how materiality should be defined – these included using a percentage of fluctuation of the ongoing charges or following accounting or auditing standards. CESR considered these options and decided that a fixed

percentage of the fluctuation in the ongoing charges figure was the best option. CESR considers a figure of 5% to be a reasonable minimum level of materiality. So (for example) an increase from 1.00% a year to 1.05% a year would be considered material. This issue will be further considered in the Commission's costs survey.

However, CESR considers it unreasonable to expect a UCITS operator to update the KID every time it knows or believes one of the elements making up the ongoing charges figure has changed or will change. Updates should happen only where there is a material change, but a change to any one section requires the whole of the KID to be revised as appropriate, except for past performance information which must only be revised annually.

**Question for the CESR consultation**

*Do you agree that a variation of 5% of the current figure is appropriate to determine whether a change is material?*

**Level 2 advice** **Box 10**

**Annual review of charges information**

The accuracy of the ongoing charges figure shall be reviewed at least annually, upon the preparation of the audited annual accounts of the UCITS. If that review shows that the new figure varies by 5% or more from the value of the published figure, it shall be treated as a material change in accordance with [Box 9 1(c)(i)] above. If the new figure varies by less than 5% from the value of the published figure, the new figure shall be published when the KID is next updated in accordance with section 14.

**Question for the CESR consultation**

*Do you agree with the proposals in Box 10?*

### Section 7: Past performance presentation

Extract from the level 1 text

*Article 78(3): 'Key investor information shall provide information on the following essential elements in respect of the UCITS concerned:*

*[...]*

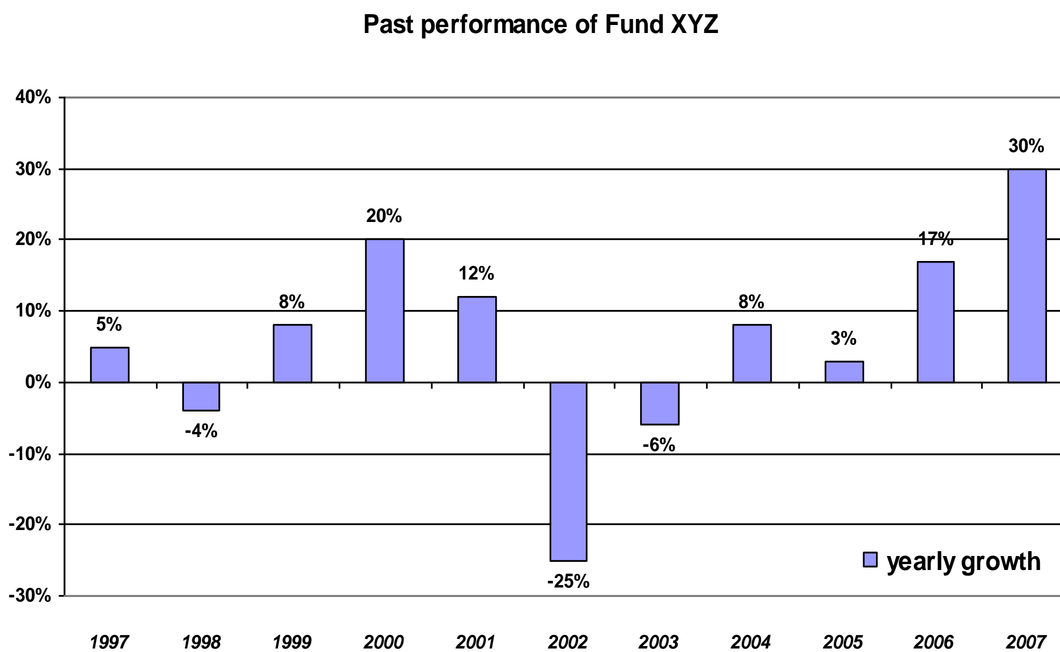
*c) past performance presentation or, where relevant, performance scenarios; [...]'*

**Level 2 advice** **Box 11**

**Presentation of past performance for funds for which past performance exists or where simulated performances are permitted**

1. For all UCITS other than structured funds, this section of the KID shall include information about the past performance of the fund. For structured funds, past performance presentation is not appropriate and the display of [performance scenarios/probability tables] shall be required.

2. The past performance information shall be presented in a bar chart as follows:




3. Funds with a track record of less than 5 complete calendar years shall use a presentation template with slots for the last 5 years only. For any year for which data is not available, the year shall be shown as a blank slot with no annotation other than the date.

4. A UCITS which does not yet have performance data for one complete calendar year shall not comply with (2) and (3). Instead, the KID shall contain a brief statement under the heading, explaining that there is insufficient data to provide a useful indication of past performance to investors.

5. The Y-axis scale of the bar chart shall be linear, not logarithmic. The scale used shall be adapted to the span of the bars shown and shall not compress the bars so that fluctuations in returns are hard to distinguish. The X-axis shall be set at the level of a 0% performance. A percentage label shall be added to each bar indicating the return that was achieved. Performance figures shall be rounded to one decimal place.

6. The bar chart layout shall be supplemented by a prominent narrative text to:
a) warn about its limited value as a guide to future performance;
b) indicate which charges and fees have been included or excluded from the calculation of past performance (for 'no-load' funds, there is no need to include reference to entry/exit fees);
c) indicate the year in which the fund came into existence.
d) indicate the currency in which past performance has been calculated.

7. The size of the performance bar chart should allow for legibility but should not exceed half a page in the KID.

Explanatory text

Evidence suggests investors can misunderstand the limits of past performance information. However, investors typically view the information as key and are likely to seek it out. CESR questioned in its preliminary advice whether past performance information should in fact be included in the KID but on balance it considered that it should.

CESR took as a starting point the approach adopted by MiFID. As the MiFID requirements in this area are relatively high-level and do not require a harmonised presentation of past performance information, CESR recommended that they should be supplemented by additional requirements specific to the KID. In addition, the current UCITS Directive requires the simplified prospectus to contain information about the historical performance of the fund and a warning that this is not an indicator of future performance. A Commission Recommendation details methods for calculating and presenting past performance, including the use of net annual returns presented through a bar chart for up to ten years, and with a comparison to a benchmark where this is appropriate.

Consequently, CESR recommended that several aspects of the MiFID standard should be supplemented by additional requirements, in order to promote the ability of investors to compare between UCITS and in order to minimise the scope for investors to misunderstand the information, given the limited space available to present it in the KID.

*Presentation of past performance*

As regards consumer testing, both formats took the same approach to displaying past performance information in that they used a bar graph approach. However, one format

showed past performance data over a 10-year period while the other variant showed past performance over 5 years :

- Findings from consumer testing revealed a strong preference among consumers and intermediaries for showing 10 years of past performance data and suggest there is no adverse impact on the ability to interpret charts. On the contrary, it appears to improve ability to compare 'steadiness' of performance.
- The majority of respondents do not have difficulty understanding that data is missing for years before the fund launch.
- A reasonable proportion of those tested continue to compare performance based on length of bars (without reference to scale) – but addition of labels to bars in Phase 2 has improved understanding over Phase 1 testing.

However, it is inevitable that past performance will be interpreted to some extent as indicative of future performance.

CESR considered the merits of prescribing the exact size and format of the bar chart. There should be a general requirement of legibility, and the past performance section should take up no more than half a page of the KID. Standards of good practice regarding fair presentation of graphs, including specifications for the scale and axis could be recommended at Level 3.
The bar chart should not be required to show a negative scale on the Y-axis if there was no negative performance. CESR does not consider that the positive and negative portions should be symmetrical (e.g. if +90% is shown, -90% must also be shown) since many funds are designed to achieve only low positive returns.

**Questions for the CESR Consultation**

*Do you agree that the above CESR proposals on past performance presentation are sufficient and workable? If not, which alternative approach would you prefer?*

**Level 2 advice** **Box 12**

**Past performance calculation methodology**

The calculation of past performance shall be made in accordance with the following requirements:
a) past performance figures shall be based on the net asset value of the UCITS;
b) past performance information shall be displayed on the assumption that any distributable income of the fund has been reinvested.

Explanatory text

CESR saw merit in clarifying some harmonised calculation rules for the past performance shown in the KID to improve comparability. As set out above, technical work has been undertaken in this area in order to provide a further standardisation.

**Questions for the CESR Consultation**

*Do you agree that the above CESR proposals on past performance calculation are sufficient and workable? If not, which alternative approach would you prefer?*

**Level 2 advice** **Box 13**

**Maintaining the past performance record**

1. Information about past performance shall be revised annually, following the end of each calendar year, so as to show the net return of the fund for that year. A duly revised KID shall be published no later than 25 business days after 31 December each year.

2. This requirement does not apply to a fund until the end of the first calendar year in which it has a track record for the whole year.

3. A KID shall not contain any record of past performance for any part of the current calendar year.

Explanatory text

CESR's views on how management companies should ensure that a KID is kept up to date, are set out more fully in section 14. CESR considers that, in order to ensure a consistent presentation of past performance information, there should be complete harmonisation of the process for bringing it up to date. On one hand, firms should not be obliged to incur the costs of frequent revision to the information; on the other hand, they should not revise the KID solely to take advantage of good short-term performance.

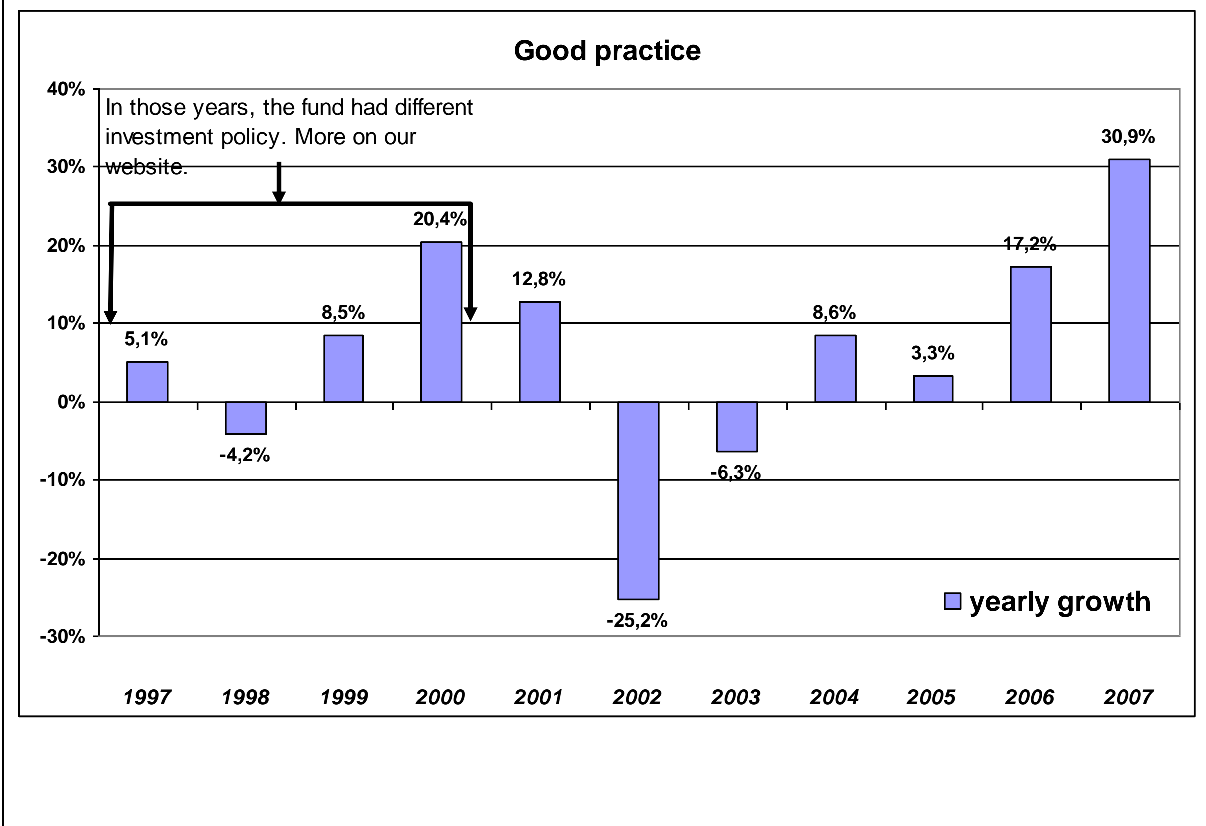
CESR recommends that every past performance record is revised annually at the end of the calendar year, so that each bar on the chart shows a complete 12 months of data. The revision should be carried out promptly to ensure, as far as possible, that all KIDs contain comparable track records. Therefore, a maximum period of 25 days should be allowed to carry out the work and issue the revised document.

**Level 2 advice** **Box 14**

**Impact and treatment of material changes**

Where a material change has occurred to a fund's investment objectives and investment policy during the period displayed in the bar chart, the past performance that was achieved prior to this material change shall be retained. The period prior to the material change shall be indicated on the bar chart and labelled with a prominent

warning that the performance was achieved in circumstances that no longer apply. An example of such a presentation is given below:




Explanatory text

Member States and data providers have developed quite different approaches regarding 'material changes'. Taking this into account, CESR discussed the opportunity and feasibility of issuing harmonised guidelines.

The majority of stakeholders agreed that it would be useful to issue such guidelines but views differed on the possibility of adopting a common definition of 'material changes' and whether this would be feasible within the current time frame. In particular, it was made clear that harmonisation of the definition of might be a demanding and time-consuming task that might not be achievable at CESR level. For that reason, CESR agreed that the issue of material changes should be addressed as far as possible independently from other related topics at national level. CESR also agreed that illustration of 'material changes' in the different Member States could be provided at Level 3.

Concerning the treatment of material changes, two options have been considered by CESR.

One option maintains, with an adequate warning, the display of past performance that occurred prior to a material change. The other option removes past performance information but under the condition of specific disclosure. The fact that part of the track

record is absent would be flagged to investors to make them aware of the 'lack of consistency' on the part of the management company.

In light of the above, CESR considers that past performance that was achieved prior to a material change should be retained, with a prominent warning included in the performance bar chart that it was achieved in circumstances that no longer apply.

**Questions for the CESR Consultation**

*Do you agree that the above CESR proposals on material changes are sufficient and workable? If not, which alternative approach would you prefer?*

**Level 2 advice** **Box 15**

**Inclusion of a benchmark alongside the fund past performance**

1. If the objectives and investment policy section of the KID makes reference to a benchmark, a bar representing the performance of that benchmark shall be included in the chart alongside each bar showing the fund's past performance.

2. UCITS which do not have past performance data over the required five or ten years are not permitted to display a benchmark as a proxy for past performance for years in which the fund did not exist.

Explanatory text

CESR recognises that information about benchmarks can be important for understanding the performance of funds, most obviously where they are managed in relation to a benchmark. For this reason, CESR recommends the mandatory inclusion of benchmark information for those funds whose objectives and investment policy indicates that they are managed in relation to a benchmark. This is not to limit the capacity of funds to include benchmarks in other circumstances, so long as these are 'clear, fair and not misleading' in relation to the performance data, and that they are appropriate to the fund.

CESR considered whether it should deliver guidelines regarding the choice of a benchmark in the section of the prospectus describing the investment objectives and policy of a UCITS. However, it was agreed that this would be out of the scope of the current work on the content of the KID.

As regards the treatment of income in benchmarks, it was discussed whether the current position in the CESR advice (i.e. that past performance information shall be displayed on the assumption that any distributable income of the fund has been reinvested where the fund reinvests income, any linked index or benchmark should be shown on the same basis) would give sufficient guidance in all cases. It was considered that even if the advice was not clear as regards what happens when the fund does not

reinvest income, there was a clear incentive for firms to show any linked index or benchmark on the same basis, so that it was unnecessary to be more specific. It was agreed that no further specifications were needed beyond the current CESR advice.

CESR also considered that it should not look to resolve in the KID any difficulties that might be raised by the impact of taxation on the fund or the investor, and therefore that investors should be warned to consider their own tax circumstances before investing.

Question for CESR consultation:

*Do you agree with this approach? If not, which alternative approach would you prefer?*

**Level 2 advice** **Box 16**

**The use of 'Simulated' data for past performance**

1. Where the past performance data of the UCITS or investment compartment or share class thereof is not available over the full required period of five or ten years, no other data shall be substituted in the blank slots. However, by derogation from this general principle, a simulated performance record for the period before data was available shall be permitted (but not required) in the following circumstances, provided that its use is fair, clear and not misleading:

a) a new share class of an existing fund or sub-fund may simulate the performance of another class, provided the two classes do not differ materially in the extent of their participation in the assets of the fund;
b) a feeder fund may simulate the performance of its master, provided:
(i) the feeder fund's strategy and objectives do not allow it to hold assets other than units of the master and ancillary cash; or
(ii) the feeder fund's characteristics do not differ materially from those of the master.

2. In all cases, following MiFID standards, there shall be prominent disclosure in the performance bar chart itself that this performance has been simulated.

3. A fund changing its legal status but remaining established in the same Member State may retain its performance record, to the extent that the competent authority of the Member State can reasonably assess that the change of status would not impact the fund's performance.

4. In the case of funds mergers through absorption, only the past performance of the absorbing fund shall be maintained in the KID.

Explanatory text

CESR considered circumstances and conditions under which the use of 'simulated' data shall be allowed.

*The use of a benchmark to represent the fund's past performance*

In considering whether to require or permit the benchmark's performance to be displayed as a proxy for the years before the fund existed, CESR took into account the pros and cons of such approach. It results from this work that investors risk mistaking the benchmark's performance in the past for the actual performance of the fund, without a proper understanding of the possible drift between the fund and its benchmark. The addition of a specific wording in the KID in order to mitigate such risk may not be sufficient. Therefore, CESR advises that displaying a benchmark as a proxy for past performance for years in which the fund did not exist should not be allowed.

*The use of a track record extension*

As regards the use of track extension, CESR considers that in some circumstances, such as the creation of a new share / unit class alongside existing classes, or the creation of a feeder fund linked to an existing master fund, this would be possible under some specific circumstances provided certain conditions are met. CESR favours an approach where continuity of the strategy and objectives between two funds is ensured not only by an assurance from the asset management company but is the consequence of a legal connection between the fund wishing to extend its track record and the fund from which this extension would be derived.

In the case of master-feeder arrangements and new share classes, there may be a built-in guarantee that the performances will be closely linked, insofar as the new share class or the feeder are, by design, invested in the same assets as the other class / fund. A track record extension can be envisaged as long as the characteristics of the feeder fund or new share class do not result in a change compared to the original fund / class. In order to assess this, reference could be made to the concept of material change as expressed above.

If the only difference between the feeder and master were the existence of a minimal pool of cash in the feeder to manage the subscriptions and redemptions, a track record extension would be considered permissible. However, in the case of a feeder investing only 85% of its portfolio in the master, with the remaining 15% invested in financial instruments offering the ability to modify the fund's characteristics (as provided for in Article 58 of the revised Directive), it should not be permissible to use the past performance of the master. Similarly, a new share class offering a different currency hedging policy to other fund classes could not refer to the past performance of those classes.

CESR is of the view that using the past performance of the master fund as simulated past performance for the feeder fund would be misleading if additional fees are charged at the level of the feeder fund. The same is true for share classes with a different charging structure.

In the case of 'parent and child' or 'predecessor and successor' funds, there is merely a commitment by the asset manager of the new fund to mirror the strategy of another fund. When it comes to 'parent and child' funds, there can be ongoing monitoring of this commitment by data providers, since both funds continue to exist; but it would be difficult for regulators to carry out such monitoring. As regards 'predecessors and

successors', this monitoring appears to be more difficult since the original fund ceases to exist, although data providers have developed processes to address this. It is noted that mergers through dissolution and creation of a new fund, which would be allowed under the UCITS IV Directive, would be comparable to a predecessor and successor scheme to that extent.

However, CESR acknowledges that when a fund simply changes its legal form – for instance from contractual form to company status for tax reasons – track record extension might also be allowed.

This should not open the door to track record extensions in all cases of parent and child or predecessor and successor schemes on the grounds that they all imply a change of legal status. In particular, in some Member States, a change of legal status might trigger other consequences, including tax issues. Moreover, it would be difficult for one Member State to determine whether a new fund asking for authorisation should be allowed to claim the performance of another fund originally located in another domicile. In addition, in some Member States it is not possible to change the legal status of a fund. However, some Members favour an even more open approach where track record extension could be allowed even if the fund changes domicile.

CESR agrees that the handling of track record extensions in past performance sources other than the KID may be based on different requirements carried out by data providers, provided the conditions set out under MiFID are met.

In light of the above, CESR is of the view that a fund changing its legal status but remaining established in the same Member State may retain its performance record, to the extent that the competent authority of the Member State can reasonably assess that the change of status would not impact the fund's performance.

*Fund mergers and track record extension*

Evidence shows that management companies tend to merge funds with a poor track record into funds with better past performance. Unit holders of the disappearing fund(s) are sometimes confronted with a display of past performance which does not reflect their actual experience. At first sight, this might not be a big issue since the KID is primarily meant to help future investment decisions, and not to serve as an ongoing information tool for an investment made in the past. However, the overall assessment of the quality of the asset management by unit holders browsing through the range of funds operated by a management company might also be biased, since poorly-performing funds disappear without leaving any trace. Thus, CESR considered that the current situation is also unsatisfactory as an aid to the decision-making process.

Simulated past performance could help in solving this problem. Three possibilities have been envisaged by CESR in its technical work, each with pros and cons (requiring the absorbing fund to display its own past performance record together with the past performance of any absorbed fund, requiring the absorbing fund to compute an 'average past performance' taking into account the past performance of the absorbed fund, requiring the absorbing fund to display only its past performance). It appears that in the case of a merger through absorption, CESR considers that only the past performance of the absorbing fund would be maintained in the KID.

CESR considered whether a disclosure to investors, such as 'On date YYYY/MM/DD the fund X absorbed fund Y', would be effective. This information does not seem likely to help investors to make a better-informed decision. It is not essential for investors, when deciding whether or not to invest in the existing fund, to know that it has previously absorbed other funds. CESR recommends that the information should nevertheless be available through other sources (prospectus or website).

CESR also discussed the case of mergers through dissolution and creation of a new fund and saw similarities with predecessor and successor schemes. Although it is understandable that the management company might want to maintain one track record irrespective of how the merger occurs, due to national practice, there is a risk of manipulation if a track record is allowed in that case. CESR considers that this issue could be covered at level 3.

**Questions for the CESR Consultation**

*Do you agree that the above CESR proposals on the use of 'simulated' data for past performance past performance presentation are sufficient and workable? If not, please suggest alternatives?*

**Section 8: Practical information**

Extract from the level 1 text:

> *'Key investor information shall clearly specify where and how to obtain additional information on the proposed investment, including but not limited to where and how the prospectus and the annual and half-yearly report can be obtained free of charge at any time, and the language in which such information is available to investors.'*

**Level 2 advice** **Box 17**

**Content of 'Practical information' disclosure**

1. The practical information section of the KID should include the following information only:

For every fund:

- Practical information not specific to any one member state, e.g. where to find other generally applicable or locally specific practical information (e.g. latest unit prices).
- Where / how to obtain further information, and in particular copies of the prospectus and the periodic reports and accounts, indicating in which language(s) these are available.
- The name of the depositary.

If applicable:

- Information about the umbrella of which the fund is a compartment and investors' rights to switch between compartments, as specified in section 10.
- Information about other share classes, as specified in section 11.

2. The KID should also contain the following statement regarding civil liability:

'[Insert name of investment company and management company] may be held liable in law for any statement contained in this document that is misleading, inaccurate or materially inconsistent with the relevant parts of the fund's prospectus.'

3. Any change to the information in this section shall be regarded as material, and shall require the KID to be revised promptly.

Explanatory text

As part of Phase 2 of the consumer testing exercise, two alternative formats of additional information within the KID were tested – one with only core items and the other with additional items of information. Consumers were asked a series of questions in order to ascertain in which format the additional information was the most useful and easiest to understand.

For both the long and short versions, only 3% of all the consumers tested found the additional information section the easiest section of the KID to understand. When consumers were asked which section of the KID they would pay the most attention to when selecting a fund, only 1% said they would pay most attention to the additional information section and 68% said they would pay least attention to it. Most of the rest of the sample paid very little attention to it.

In addition, the results of the intermediary testing revealed that the additional information section was too long and this was particularly so for complex funds. Intermediaries also felt the additional information was unnecessary and the least likely of all the sections to be read in light of the fact that investors could refer directly to the source of additional information.

The CESR working group discussed these results and agreed to improve the section by shortening the list of additional information. It was agreed that the following items, previously proposed for inclusion, should be dropped:

- A warning that the fund's Home State taxation regime may impact investors in other states;
- Where to get further information, specific to country of residence;
- Name of the fund auditor;
- Date the fund was created;
- Information about how to buy and sell units in the fund;
- How to make a complaint in relation to the management of the fund.

CESR also agreed the initial text referring to the NAV calculation should be changed to a reference to the frequency of redemption and subscription, and that both it and the information on treatment of income should be moved to the Objectives and Investment Policy section. It was also agreed that the civil liability statement that was proposed in the versions of the KID that were tested, would be more effective if redrafted as a more positive statement of investor rights rather than a disclaimer.

As discussed in section 1, many consumers who took part in the consumer testing exercise felt the word 'additional' created an impression that the information within that part of the KID was not key and could be ignored. As such, CESR seeks views on whether the information should be called 'Practical information' instead. See 'Question for the CESR consultation' at section 1.

**Question for the CESR consultation**

*Do you agree with the proposals in Box 17?*

**Use of signposting to other sources of information**

Extract from the level 1 text

Article 78(3) states:

*'Key investor information shall provide information on the following essential elements in respect of the UCITS concerned:*

*[...]*

*These essential elements shall be understandable by the investor without any reference to other documents.'*

Extract from the Mandate of the Commission

*CESR is invited to advise the Commission on the following questions: What sort of cross-references to other documents or "signposts" might be permitted, apart from those which are directly referred to in the Directive?*

**Level 2 advice** **Box 18**

1. Signposts to other sources of information should be permitted under Article 78(3) as long as the number of cross-references is kept to a minimum and the referenced material is not fundamental to investors' understanding of the investment. In this way, the ability of the KID to provide the necessary disclosures in a stand-alone manner should not be undermined.
2. These other sources of information may include sources other than the prospectus and annual/half-yearly reports. Cross-references to the website of the UCITS or the management company (in addition to a part of it containing the prospectus and the periodic reports) should also be permitted.
3. It should be acceptable to include several different signposts within the KID, rather than a single, general reference to the prospectus and annual/half-yearly reports. These signposts should be to the specific section of the relevant source of information; for example, for performance fees, the cross-

reference from the Charges section of the KID might be to the section of the prospectus dealing with charges.

Explanatory text

CESR considers that it should be possible to include signposts or references to other information in a way which would not compromise the ability of the investor to understand in full the essential elements listed in Article 78(3).

In formulating its advice, CESR has taken account of the following considerations:

a. The purpose of including the final sentence in Article 78(3) was to ensure that firms fulfil their detailed disclosure requirements in the KID in full.

b. The Commission had stated that in the co-legislators' views, the use of references in the essential information part of the KID might undermine the extent to which the KID functions effectively in a stand-alone manner, particularly where the referenced material can be considered essential for understanding the investment proposition.

There is a difference between sign-posting to information which might be useful to the investor (but which would not be required or necessary for the investor to understand the essential elements), and sign-posting to important information to such a degree that full comprehension of the essential elements without it would not be possible.

If sign-posting to other sources of information is used, it should be done in such a way as to make clear that the prospectus and reports are the primary sources of information for investors, and should not downplay their significance.

As to keeping cross-references to a minimum, CESR recommends that there should not generally be more than one cross-reference appearing in each section of the KID.

**Question for the CESR consultation**

*Do you agree with the proposals in Box 18?*

**Section 9: Circumstances in which a KID should be revised.**

CESR has addressed what might constitute a material change to each of the principal sections of the KID, and what action should be taken in response to such a change. CESR has also considered what measures should be taken to ensure the KID is kept up to date, whether or not there are any material changes.

<u>**Level 2 advice**</u> **Box 19**

1. The management company shall review the KID of each UCITS as frequently as is necessary to ensure that it continues to meet the requirements for key investor information specified in Articles 78(2) and 79(1).

2. As a minimum, a review in accordance with (1) shall be carried out:
(a) Prior to or following any material change, as specified in each of sections 4 to 8;
(b) Prior to any of the following events:
(i) a proposed change to the fund rules, instrument of incorporation or prospectus not covered by (a);
(ii) in relation to a UCITS which is to be the receiving UCITS in a merger under Chapter VI, the provision of its key investor information to the unit-holders of the merging UCITS in accordance with Article 43(3)(e);
(iii) the submission of a notification request in accordance with Article 93(2)(b), unless (v) below has been complied with in the previous [6] months for the purpose of that request;
(iv) the translation of the key investor information where required by Article 94(1)(b).
(c) Every twelve months unless (a) or (b) apply during that time.

3. The management company shall promptly publish a revised version of the KID, taking such steps as are necessary to ensure that it is made available in compliance with Article 80, in the following circumstances:
(a) for funds other than structured funds, in accordance with Box 13.
(b) following any review in which the management company has identified a change necessary for compliance with (1).

4. For the purposes of (3), 'promptly' shall mean:
(i) in relation to (2a), within the timescale specified in sections 4 to 8 respectively;
(ii) in relation to (2b(i)) above, so that the existing version is withdrawn and the revised version is made available simultaneously with the change coming into effect;
(ii) in relation to (2b(ii) to (iv)) above, so that the revised version is available to be used for the stated purpose;
(iii) in all other cases, so that the revised version is published and made available no later than twelve months after the date of publication of the existing version.

<u>Explanatory text</u>

A management company is under a general obligation to ensure at all times that each KID is kept sufficiently up to date to comply with Articles 78 and 79. Furthermore, it is free to update each KID as frequently as it wishes, subject to any specific restriction

(e.g. not showing past performance history for part of the current calendar year). Nevertheless, there needs to be some definition of this obligation, to ensure management companies are not forced to carry out excessively frequent minor revisions of their KIDs.

In addition to the events identified as material changes, CESR considers that there are other events for which it is important to ensure that the KID is up to date and accurate. Any change to the fund rules, instrument of incorporation or prospectus should prompt a review of the KID to ensure there are no consequential changes that need to be signalled to prospective investors. Such a review should be carried out in good time so that, if an update to the KID is necessary, the revised version is available to coincide with the implementation of the change.

CESR considers that it is also appropriate to review the KID before any initiative that is likely to result in a significant number of new investors acquiring units in the fund. CESR has specified the cases of:

- a fund merger, where the unit-holders of the merging UCITS have to be given a copy of the KID of the receiving UCITS in order to decide whether they wish to remain invested in the fund;
- a notification to market units in another Member State; if the notification is one that requires a new translation of the KID to be prepared, the review should be done prior to that; but if there is a delay of more than 6 months between the preparation of the translation and the submission of the notification, a further review should be done prior to the notification to check that everything remains accurate.

For funds (other than structured funds) that will be required to show a past performance record, CESR recommends that it is sufficient to revise that information on an annual basis, on the completion of each calendar year. The revision will be required to be completed by the 25th business day of each calendar year to ensure as much consistency as possible in the data shown in all KIDs.

For funds whose ongoing charges figure is liable to vary slightly from year to year, as a result of fluctuations in the amount of expenses charged to the fund, CESR considers that a management company may treat as immaterial any change that results in a fluctuation of less than 5% of the published figure. So in such cases, it is not necessary to publish an immediate update of the KID. Nevertheless, where a figure varies from the previous year it is necessary to show it in the KID to ensure the document is fair, clear and not misleading. This should be done on the next occasion the KID is updated for some other purpose, or at the next periodic review, whichever is the sooner.

CESR therefore recommends that, unless a material change or other significant event has occurred, it should be sufficient to review and revise a KID once every 12 months to keep it up to date. This should enable many management companies to carry out a single annual review of the whole KID to coincide with the annual revision of its past performance record, thus avoiding unnecessary duplication of work.

| **Question for the CESR consultation** |
| --- |
| *Do you agree with the proposals in Box 19?* |

**Special cases - how the KID might be adapted for particular fund structures**

Extract from the Mandate of the Commission

*"According to Article 78(7)(b), due regard must be given to UCITS having different investment compartments, offering different share classes, or having fund of funds structures, master-feeder structures or where the UCITS is structured, capital protected or takes some other comparable form. KII should properly reflect these specificities.*

*CESR is invited to advise the Commission on the following question: How should the KII reflect all the characteristics of the special cases outlined under Article 78(7)(b) that are relevant for the retail investor making an investment decision, for instance the characteristics of master-feeder structures?*

## Section 10: Umbrella structures

Extract from the level 1 text

*Article 78 (7): "The Commission shall adopt implementing measures which define the following:*

*[....]*

*(b) the detailed and exhaustive content of the key investor information to be provided to investors in the following specific cases:*

*(i) for UCITS having different investment compartments, the key investor information to be provided to investors subscribing to a specific investment compartment, including how to pass from one investment compartment into another and the costs related thereto;*

**Level 2 advice** **Box 20**

1. Where a UCITS consists of two or more investment compartments, a separate and stand-alone KID should be produced for each individual compartment.

2. The KID should indicate, as part of the 'Practical information' section, that the fund being described is a compartment of an umbrella fund and should state the name of the umbrella. It should indicate whether or not the assets and liabilities of each compartment are segregated by law and how this might affect the investor.

3. If the UCITS operator sets a charge for the investor to switch his holding from units in one compartment to units of a different compartment, and that charge differs from

the standard charge for buying or selling units, the switching charge should be stated separately in the 'Charges' section.

Explanatory text

Many UCITS, especially those constituted as an investment company, have adopted the umbrella structure whereby a single UCITS may consist of two or more compartments (also known as sub-funds) that each have individual investment objectives.

For the purposes of producing the prospectus and the periodic reports and accounts, the Directive treats the umbrella UCITS as a single entity. However, since the umbrella structure is primarily a means of organising the investment vehicle efficiently, the UCITS operator will typically market specific investment compartments rather than the entire range comprising the umbrella UCITS. Likewise, many investors will be interested in receiving information about one particular compartment and will not necessarily want to know about the rest of the umbrella.

CESR recommends that a stand-alone KID be produced for each investment compartment. This will enable investors to see the essential information about the compartment at a glance, and will facilitate comparison between the funds of different operators. It will also help operators who have notified some but not all compartments of an umbrella to be marketed in another Member State.

CESR does not in principle favour the production of a single KID document for an umbrella UCITS in which the separate disclosures for each compartment are compiled in sequence. A document that combines the details of several compartments is more likely to detract from the impact of the information about each particular compartment, than a stand-alone KID. As a result, the investor might be deterred from reading the document or might fail to appreciate the significance of the information. However, CESR notes that such an approach may be necessary where local marketing regulations require it.

Subject to local marketing regulations, a UCITS or a distributor may produce marketing documents that summarise the features of two or more compartments of the same umbrella, provided such documents are in addition to the KID, not in substitution for it.

The statement that the KID is describing a compartment of an umbrella UCITS is required to identify the UCITS, as noted in section 1 above. It may be included in the section indicating where to obtain further information, since the investor needs to know the name of the umbrella in order to request copies of its prospectus and periodic reports.

Many Member States recognise a 'protected cell' structure which ensures segregation between the assets of individual compartments, so that the failure of one would not affect the other compartments in the same UCITS. However, since this structure does not apply universally, CESR recommends that the KID should make clear whether or not it is applicable in each case.

Article 78 (7)(b)(i) requires the key investor information to include '...how to pass from one investment compartment into another and the costs related thereto'. A reference to the right to switch between sub-funds can be added to the 'Practical information' section. The costs of switching, if they differ from the costs of buying and selling units, should be explained in the 'Charges for this fund' section of the KID.

**Question for the CESR consultation**

*Do you agree with the proposals in Box 20?*

**Section 11: Share classes**

Extract from the level 1 text

*Article 78 (7): "The Commission shall adopt implementing measures which define the following:*

*[....]*

*(b) the detailed and exhaustive content of the key investor information to be provided to investors in the following specific cases:*

*(ii) for UCITS offering different share classes, the key investor information to be provided to investors subscribing to a specific share class;*

**Level 2 advice** **Box 21**

1. Where a UCITS consists of more than one class of units or shares, the UCITS or its management company shall, for each class of units or shares that it promotes to the public within the Community or any part of it, ascertain the information required by Article 78 (3) in relation to that class. The UCITS or its management company shall prepare a KID for each such class, based on that information, except as permitted by the following paragraphs:

a) the key investor information pertinent to two or more share classes of the same UCITS may be combined into a single KID, provided that the resulting document fully respects all other requirements relating to length and presentation.

b) the UCITS or its management company may select a share class to represent one or more other classes of the UCITS, provided it is satisfied on reasonable grounds that to do so is fair, clear and not misleading to prospective investors in those other classes. The UCITS or its management company shall keep a record of which other classes are represented by the selected class, and the grounds justifying that decision. A KID based on the representative share class may be provided to investors in the other classes so represented in satisfaction of the requirements of the Directive relating to the duty to provide key investor information.

2. Under no circumstances shall specific features of different classes be selected and combined into a composite profile of a representative class.

3. A KID shall indicate, if applicable, where investors can obtain information about the other classes of that UCITS that are available to them in their own Member State.

Explanatory text

It is likely that the majority of UCITS make some use of share class structures, and many have relatively complex structures in order to accommodate differences relating to:

- distribution channels
- fee-charging structures
- currencies in which units are dealt
- investor tax status
- treatment of fund income

Although a UCITS may have numerous classes, not all of them will necessarily be available to any one investor. For instance, some classes may be offered only through a particular distribution arrangement, or may be restricted to either the home Member State or a specific host Member State.

CESR considers that the KID requirements are applicable in principle to every share class that is sold in conformity with Article 3(b) or (c). Consequently, if the UCITS raises capital for investment in a particular share class without promoting the sale of units in that class to the public within the Community, or if that class is sold only to the public in third countries, then no KID is required for it.

The question of whether a share class designed for institutional investors is being promoted 'to the public' is not one which this Advice can answer definitively. If such a class is being promoted to the public, a KID must be available to be provided to investors, even if potential institutional investors opt not to receive the document.

As previously explained in its February 2008 advice to the Commission, CESR believes that where possible, the management company should not be obliged to produce a separate KID for every share class, in order to avoid imposing unnecessary additional costs on providers. The details of two or more classes could be combined into a single KID if this can be done without making the document too complicated or crowded. The management company could also be permitted to select a representative class in cases where there is sufficient similarity between classes.

In determining whether the use of a representative class would be fair, clear and not misleading, the UCITS management company must consider which is the most suitably representative class having regard to the characteristics of the fund, the nature of the differences represented by each class, and the range of choices on offer to each investor or group of investors. The management company should ensure in particular that the description of risk factors does not omit any material risk applicable to any of the other classes.

Where charging structures differ between classes, and a particular class can be clearly identified as having the highest overall charge, that class might be the most suitable. Using it as the representative class would avoid the risk of the charges likely to be incurred by an investor being understated (and correspondingly would avoid the fund's past performance being overstated). However, it may be the case that no single class can unambiguously be said to have the highest overall charge (for instance, because one class has a higher initial charge whereas another has a higher ongoing charge). If so, the management company should take account of other factors; for example, if the fund is stated as being unsuitable for investors who plan to hold it for less than a specified period, the most suitable class might be the one that represents the lowest overall cost if held throughout that period.

The management company would, however, need to consider whether selecting a representative class with high costs might mislead prospective investors. This could happen if investors fail to realise that a class with a lower charging structure is available. There may be other bases for choosing the representative class, e.g. the difference between distributing and accumulating classes in an income-generating fund.

When considering the use of a representative class, the management company will need to take account of which classes are marketed to the public in which Member States. It would be possible, for example, for a class to have its own KID in one Member State and be represented by another class in another Member State.

| **Question for the CESR consultation** |
|---|
| *Do you agree with the proposals in Box 21?* |

**Section 12: Fund of funds**

Extract from the level 1 text

*Article 78 (7): "The Commission shall adopt implementing measures which define the following:*

*[....]*

*(b) the detailed and exhaustive content of the key investor information to be provided to investors in the following specific cases:*

*(iii) for fund of funds structures, the key investor information to be provided to investors subscribing to a UCITS, which invests itself in other UCITS or other collective investment undertakings referred to in Article 50(1)(e) ;*

| **<u>Level 2 advice</u>** | **Box 22** |
|---|---|

1. The description of the objectives and investment policy of a fund of funds should comply with section 4 by explaining briefly how the other collective undertakings are selected and their performance assessed.

2. The description of the risk factors of a fund of funds should take account of the risks posed by each underlying collective undertaking, to the extent that these are likely to be material to the UCITS as a whole.

3. The description of the charges that investors will incur should take account of any charges that the UCITS will itself incur as an investor in the underlying collective undertakings. Any costs of buying and selling shares or units in those undertakings should be treated as transaction costs of the UCITS, in accordance with section 6. Any ongoing charges levied by the underlying collective undertakings should be reflected in the UCITS' calculation of its own ongoing charges figure, in accordance with the methodology set out in Annex 2.

Explanatory text

The essential difference between a fund of funds and other UCITS is not in the structure of the fund but the nature of its investment objective and policy. Consequently, CESR recommends that, with the exceptions noted in the draft Level 2 text, a fund of funds should be regarded as a single fund that invests in a portfolio of other collective undertakings, as opposed to (e.g.) a portfolio of securities or money-market instruments. Its KID should be prepared on the basis that the investor does not wish or need to be informed in detail about the individual features of each of the underlying collectives, which in any case are likely to vary from time to time if the UCITS is being actively managed.

However, in order for the KID to deliver effective disclosure of the fund of funds' objective and investment policy, risk factors, and charging structure, it is necessary to 'look through' to the characteristics of its underlying funds, in the manner described above.

The description of the fund of funds' objective and investment policy should briefly explain the manager's approach to the selection of underlying financial instruments to achieve the fund's objectives, but any generalised statement that (for example) 'the fund selects the most appropriate funds after careful quantitative and qualitative assessment' should be avoided. The description could, where appropriate, reflect that some asset managers adopt a purely quantitative approach, selecting the funds with the best risk-adjusted performance in the past (e.g. based on their Sharpe ratio). Others may build a real 'fund portfolio' with the aim of avoiding correlations between funds, or they may select only funds paying high dividends.
It is not envisaged that any special measures are required in relation to the past performance of a fund of funds, or its additional information section.

**Question for the CESR consultation**

*Do you agree with the proposals in Box 22?*

## Section 13: Feeder funds

Extract from the level 1 text

*Article 78 (7): "The Commission shall adopt implementing measures which define the following:*

*[....]*

*(b) the detailed and exhaustive content of the key investor information to be provided to investors in the following specific cases:*

*(iv) for master-feeder structures, the key investor information to be provided to investors subscribing to a feeder UCITS;*

The concepts of a feeder UCITS and a master UCITS are defined in Article 58. By requiring the feeder to invest at least 85% of its assets in the master UCITS, the feeder's characteristics and behaviour will be substantially similar to those of the master.

Although Article 63 stipulates that the prospectus of a feeder must describe the feeder's features compared with its master, this Article does not address the key investor information of the feeder. Nor is there any provision in the Directive requiring investors in a feeder to be provided with the KID of the master, whereas that document must be attached to the information pack that the feeder provides to its competent authority.

**Level 2 advice** **Box 23**

1. A separate KID shall be produced for each feeder UCITS, describing all of the relevant features of the feeder mentioned in Article 78 (3). It is not sufficient to mention only those points where the feeder differs from its master UCITS.

2. The description of objectives and investment policy shall explain that the UCITS is a feeder and will invest 85% (or some higher percentage as stated in the prospectus) of its assets in a named UCITS. This shall be supplemented with a description of the master UCITS' objectives and investment policy, either indicating that the feeder UCITS' investment returns will be very similar to those of the master UCITS, or else explaining how and why they may differ.

3. Where the risk and reward profile of the feeder UCITS differs in any material respect from that of the master, this fact and the reason for it should be explained in the risk section.

4. The past performance information must be specific to the feeder UCITS, and should not simply reproduce the performance record of the master UCITS. A feeder UCITS may show the past performance of its master UCITS as a benchmark. Where section 7

permits, the past performance of the master UCITS may be shown for the years before the feeder existed or before it operated as a feeder of that master UCITS.

5. The section on charges should reflect both the costs of investing in the feeder UCITS and the fees and expenses, if any, that the master UCITS may charge to the feeder UCITS. The figures disclosed for buying and selling charges should combine those charged to the feeder UCITS by the master UCITS (if any) with those charged by the feeder UCITS to its investors. The ongoing charges figure for the feeder UCITS should combine the costs of both feeder and master in accordance with the methodology set out in Annex 2.

6. The section on practical information should be specific to the feeder UCITS as the information will, in most respects, differ from that of the master UCITS. It should state, in addition to the information required for all other funds:
a) that the master UCITS' prospectus, KID, and periodic reports and accounts, are available to unitholders of the feeder UCITS upon request, how they may be obtained, and in which language(s);
b) whether the items in (a) are available in paper copies only or in a durable medium, and whether any fee is payable for items not subject to free delivery in accordance with Article 63 (5);
c) if it is the case, that the master UCITS is established in a different Member State to the feeder UCITS and that this may affect its tax treatment.

Explanatory text

The description of the feeder UCITS' risk and reward profile should not be materially different to that of the corresponding section in the master UCITS' KID. Indeed, it should be possible for the feeder to copy information from the KID of the master wherever it remains relevant. However, it should be supplemented by a statement that any ancillary assets held by the feeder could slightly modify its risk profile compared to the master, and a warning specific to any risks inherent to these assets, such as the use of derivatives. In addition, the liquidity risk for investors in the feeder UCITS should be mentioned, explaining the alignment with the purchase / redemption arrangements in place for the master UCITS.

**Question for the CESR consultation**

*Do you agree with the proposals in box 23?*

**Section 14: Structured funds, capital protected funds and other comparable UCITS**

Extract from the level 1 text

*Article 78 (7): "The Commission shall adopt implementing measures which define the following:*

*[….]*

*(b) the detailed and exhaustive content of the key investor information to be provided to investors in the following specific cases:*

*(v) for structured, capital protected and other comparable UCITS, the key investor information to be provided to investors in relation to the special characteristics of such UCITS;*

In its initial advice to the Commission, CESR noted that past performance was not adapted to all types of funds, especially for structured funds[7] such as formula funds, capital protected funds and comparable funds. These funds raise specific concerns regarding the type of information which must be disclosed to investors and the corresponding illustration techniques.

Findings from consultation and consumer testing have shown that presentation of performance scenario can help investors' understanding of possible payoffs of such fund types.

The presentation of information relating to structured funds was only tested in the qualitative work on the consumer testing. For these funds, two approaches were taken to displaying information about possible performance scenarios. One variant used 4 line graphs showing very favourable, favourable, flat and weak performance scenarios while other variant used a table showing four different scenarios and the associated fund prices at maturity with explanations as to how these were arrived at.

Generally speaking the graphical approach that was presented was seen by consumers to be difficult to approach. They did not find it intuitive and felt that they had to read the explanations in considerable detail (and in some cases to have additional knowledge of the operation of such funds) in order to be able to interpret them). Consumers also felt that showing four different scenarios was too many; in part because the space available meant that each individual graph was quite small and hard to read.

The majority of consumers felt the table was the best way of presenting performance scenario information for complex funds. They welcomed the use of monetary sums to help them understand potential returns. A suggestion to further improve the table was showing (more clearly and in the table itself rather than in the accompanying text) the initial amount invested in the fund.

[7] Structured funds typically promise predetermined pay-offs at given dates (fixed investment horizon), which may depend on computations (formulas) elaborated on certain parameters, such as financial indexes as well as single given instruments or other assets. Moreover, the techniques used often require closing the offering of the shares of structured funds within a limited period from its initial launch (generally up to six months for formula funds). Hence, by nature there is no past performance.

CESR considers that for those funds, the objectives and investment policy disclosure shall be supplemented by performance scenarios which illustrate the risk and reward trade-offs of the fund. The use of back-testing should not be allowed in the KID.

The work carried out by CESR in that respect has allowed envisaging two options for performance scenarios:

> Option A: prospective scenarios showing the return of the fund under favourable, adverse and average market conditions;
>
> Option B: tables showing the probability of certain defined events: achieving a negative return or achieving a positive return worse, equal to or better than the risk-free rate.

A large majority of CESR Members consider that option A should be preferred. However, both options are presented for consultation.

**Option A - Prospective scenarios through the use of graphs or tables**

**Level 2 advice** **Box 24A**

**The presentation of performance scenarios for structured funds**

1. For structured funds, the presentation of past performance is inappropriate. For these funds, the objectives and investment policy section of the KID shall instead include an explanation of how the formula works or how the pay-off is calculated. The explanation should be clear, fair and not misleading.

2. The explanation should be completed by an illustration, presented through three scenarios, of the fund's potential performance. These scenarios shall show the return of the fund under favourable, adverse and flat market conditions.

3. The presentation of the performance scenarios and the scenarios chosen to illustrate how the formula works shall be clear, fair and not misleading.

Explanatory text

The use of prospective scenarios involves calculating the expected return of the fund under favourable, adverse, or average hypotheses regarding market conditions (this approach is generally referred to as the 'what if?' representation). The methodology is based on the application of the formula on which the fund functioning is based, to certain market conditions that would trigger a positive, neutral or negative return for the investor. This is intended to give the investor a better understanding of how the

fund works by providing a simple answer, in the form of examples, to the question 'how much would I get if a certain event happens?'.

Findings from the consumer testing show that prospective scenarios lead to a good level of understanding by investors. Feedback from the technical consultation has shown that, between the two options which were considered, from a methodological point of view this kind of scenario deserved the wider support.

CESR has considered the advantages and drawbacks of using prospective scenarios.

Prospective scenarios would represent information which is complementary to and consistent with the information addressed in other sections of the KID. The examples could illustrate helpfully how a (relatively complex or sophisticated) fund will work in practice. They may also be a suitable way of providing investors with a meaningful representation of the risk and reward profile of the fund, notably any 'tail' risks described in that section.

Prospective scenarios are already used in several Member States. They would be easy for UCITS providers to implement at limited cost and easy for regulators to enforce.

The scenarios should be straightforward and could be selected to illustrate how the fund would function in extreme market conditions. The scenarios could be ones that an average investor would not have previously considered. Including a worst-case scenario would allow investors to understand whether or not there is a guarantee or a capital protection.

However, concerns have been expressed that prospective scenarios could be misleading for investors. Scenarios should not, for instance, cover only favourable scenarios or imply a guarantee of future performance.

CESR recognises that, in order to ensure comparability of funds, there will have to be consistency in the choice of prospective scenarios used. In order to achieve this, it may be necessary to issue more detailed guidelines at Level 3 in order to foster a more harmonised approach to selection of the scenarios.

CESR formed the view that the presentation table would be more understandable than a graph. It allows easy comparison with possible outcomes from investment in a risk-free asset which is a clear illustration, for instance, of the hidden costs of investing in a guaranteed fund. However for structured funds with complex formula a presentation in the form of tables may not be adapted and graphs may be more appropriate. There is a strong consensus to use tables to display the three scenarios, but the option of using graphs has been kept open in order to take account of these more complex funds. There is a clear majority within CESR Members in favour of the use of prospective scenarios (Option A).

OR

**Option B - Performance scenarios based on probability tables**

| **Level 2 advice** | **Box 24B** |
|---|---|
| **The presentation of performance scenarios for structured funds** | |

CESR

1. For structured funds, the presentation of past performance is inappropriate. For these funds, the objectives and investment policy section of the KID shall instead include an explanation of how the formula works or how the pay-off is calculated. The explanation should be clear, fair and not misleading.

2. The explanation should be completed by an illustration, presented through three scenarios, of the fund's risk and reward trade-offs. These scenarios shall show tables showing the probability of certain defined events:

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

Explanatory text

Structured funds typically promise predetermined pay-offs at given dates (a fixed investment horizon), which may depend on certain parameters, such as the return or the volatility of a financial index.

Consequently, assumptions can be made about the processes that determine the evolution of these parameters to enable a fund's value to be calculated at the end of its given time horizon or, alternatively, for a full set of possible trajectories of the fund's value to be simulated if the above-mentioned processes are assumed to be stochastic in nature (that is, subject to random deviations).

While the distribution of simulated performances already provides details about the potential reward offered by the fund, investors' ability to make use of such information may be seriously hampered by its inherent excess of granularity. A table can be constructed to sort the data showing the possible performances of the fund, according to their correspondence to four[8] major events: (1) the return of a negative performance; positive results of returns (2) lower, (3) in line with, or (4) higher than those which could be achieved by investing in risk-free assets. The detailed methodology is provided in Annex 4.

Feedback from the consumer testing suggested that out of the two options, the table showing the probabilities corresponding to different possible performance scenarios for the fund seemed to fare slightly better in terms of the level of clarity it offered investors. However, a majority of respondents to the technical consultation expressed concerns as regards the use of probability tables for which the methodology used would be flawed.

CESR has considered the advantages and drawbacks of using probability tables.

Probabilistic performance scenarios may be a suitable way to provide investors with a meaningful risk and reward disclosure. Investors might easily grasp the content of the information that the table conveys. It would be complementary to, and consistent with, the other KID sections. The option would not be difficult for UCITS operators to

[8] An additional fifth event is the realisation of conditions that activate a guarantee, if this is established by the rules of the fund. In these circumstances, the event included in the performance scenarios table would capture those cases when the performance of the fund, which would be per se negative (or at any rate below the target), can be taken as equal to zero (or to another predetermined value) because of the intervention of the guarantee.

implement and would not introduce any additional liability for them. It would help clarify the limits of the responsibility attached to the disclosure of the risk and reward profile of the fund in the prospectus or KID.

However, the use of probabilistic tables also presents drawbacks:

- The computation of probabilities of the performance scenarios implies the use of assumptions and models, which increases the risk of errors.
- Investors might over-rely upon the figures displayed in the probabilities table, focusing only on the probability of favourable scenarios.
- Exposures to particular (rare and extreme) events are not better explained to investors through their impact on the performance scenarios, this is due to the fact the probability table does not describe the specific shape of the distribution of potential returns. However, since this distribution must be estimated through the simulations, the impact of rare and extreme events could always be captured as far as the conditional expectations of the performances of the fund corresponding to each of the scenarios are also displayed.
- Comparison of likely fund performance with returns of a risk-free asset is possible, although this is carried out through simulations.
- There are concerns regarding the ability of regulators to monitor the application of probability tables, taking into account the availability at the supervisory level of the specific technical and human resources needed to verify the correct implementation of this approach.

For funds which are actively managed, it may not be reliable to represent the contribution of the management style to fund returns of different funds.

**Questions for the CESR Consultation**

*Do you agree with the above CESR proposals on performance scenarios? In particular which option (A or B) should be recommended? If not, please suggest alternatives.*

**Other Issues**

**Section 15: Medium and timing of delivery, including use of a durable medium**

Extract from Level 1 text

*Article 81:*
*(1) Member States shall allow investment companies and, for each of the common funds they manage, management companies, to provide key investor information in a durable medium or by means of a website. A paper copy shall be delivered to the investor on request and free of charge.*
*In addition, an up-to-date version of the key investor information shall be made available on the website of the investment company or management company.*
*(2) The Commission may adopt implementing measures which define the specific conditions which need to be met when providing key investor information in a durable medium other than on paper or by means of a website which does not constitute a durable medium.(…)'*

*Article 75:*
*'(2) The prospectus may be provided in a durable medium or by means of a website. A paper copy shall be delivered to the investors on request and free of charge.*
*(4) The Commission may adopt implementing measures which define the specific conditions which need to be met when providing the prospectus in a durable medium other than paper or by means of a website which does not constitute a durable medium.(…)'.*

Extract from the Mandate of the Commission

*CESR is invited to advise the Commission on:*
*- the specific conditions which need to be met when providing <u>KII</u> in a durable medium other than on paper or by means of a website which does not constitute a durable medium (Article 81(2) of the UCITS Directive) ;*
*- the specific conditions which need to be met when providing the <u>prospectus</u> in a durable medium other than on paper or by means of a website which does not constitute a durable medium (Article 75(4) of the UCITS Directive).*

| **<u>Level 2 advice</u>** | **Box 25** |
|---|---|
| **Conditions under which a durable medium might be used and requirements to be met when using the Internet** | |

1. Investment companies or management companies can provide investors or intermediaries with KID and/or the prospectus in a durable medium other than on paper only if:

(a) the provision of that information in that medium is appropriate to the context in which the business between the firm and the client is, or is to be, carried on; and

(b) the person to whom the information is to be provided, when offered the choice between information on paper or in that other durable medium, specifically chooses the provision of the information in that other medium.

2. Where investment companies or management companies provide investors or intermediaries with KID and/or the prospectus by means of a website and that information is not addressed personally to the client, the following conditions must be satisfied:

(a) the provision of that information in that medium is appropriate to the context in which the business between the firm and the client is, or is to be, carried on;

(b) the client must specifically consent to the provision of that information in that form;

(c) the client must be notified electronically of the address of the website, and the place on the website where the information may be accessed;

(d) the information must be up to date;

(e) the information must be accessible continuously by means of that website for such period of time as the client may reasonably need to inspect it.

3. These conditions shall apply to intermediaries, when providing KID to their clients or potential clients in a durable medium other than on paper or by means of a website.

4. For the purposes of this Article, the provision of information by means of electronic communications shall be treated as appropriate to the context in which the business between the firm and the client is, or is to be, carried on if there is evidence that the client has regular access to the internet. The provision by the client of an e-mail address for the purposes of the carrying on of that business shall be treated as such evidence.

Explanatory text

A definition of 'durable medium' has been provided by the UCITS IV Directive at Level 1 (Article 2.1(m)).

When defining conditions under which a durable medium might be used and requirements to be met when using the Internet, CESR recommends retaining the same definition laid down in MiFID Level 2 provisions.

Other directives - most notably the Distance Marketing Directive[9] - contain specific conditions to be met when providing information in a durable medium other than paper.

[9] Directive 2002/65/EC of the European Parliament and of the Council of 23 September 2002 concerning the distance marketing of consumer financial services and amending Council Directive 90/619/EEC and Directives 97/7/EC and 98/27/EC

This issue has been partially addressed by CESR in its February 2008 advice when envisaging different information layers and interaction with other directives.

The Commission in its request for advice suggests, as a matter of consistency, to retain the same definition as provided by MiFID Level 2 provisions.

Moreover, it might be useful to give examples to illustrate this definition. Indent number 20 of the Distance Marketing Directive adds that: '*durable mediums include in particular floppy discs, CD-ROMs, DVDs and the hard drive of the consumer's computer on which the electronic mail is stored, but they do not include Internet websites unless they fulfil the criteria contained in the definition of a durable medium*'. It might be necessary to update this list. For instance, a file (PDF, Word or other formats that prevent alteration, modification or falsification) that can be downloaded from the website could be a durable medium for that purpose.

In its request for advice, the Commission reminds CESR of the obligation of the management company to:

- provide investors with the KID in good time before the investment (Article 80(1));
- provide the KID to product manufacturers and intermediaries selling or advising investors on potential investments in UCITS or in products offering exposure to UCITS upon their request (Article 80(2)).

The Commission indicates that Article 81 specifies that the delivery could be done in a durable medium or by means of a website. Moreover, co-legislators agreed a requirement that an up-to-date version of the KID should always be published on the website of the investment company or a management company.

The advice on Articles 75(2) and 81(1) is intended to specify the minimum requirements investment companies or management companies and intermediaries must comply with, when providing with KID and/or the prospectus on a medium other than paper, so that it can be considered as a 'durable medium' as referred to in the above Level 1 provisions. In particular, it shall specify the requirements to be met by management companies or intermediaries using a website to make the KID available, so that this means can be considered as equivalent to a durable medium.

Indeed, where the KID is to be delivered in a durable medium other than paper or by a website which does not constitute a durable medium, additional safety measures to those used when delivering the paper form may be necessary to maintain the integrity of the information, prevent alterations that undermine its comprehensibility and effectiveness, and avoid manipulation or modifications by unauthorised persons, or any other interventions which may have a negative effect on the content, availability and durability of the information.

**Questions for the CESR Consultation**

*Do you agree with the proposals in box 25? If not, what alternative approach would you suggest?*

**Section 16: Other possible Level 3 work**

CESR notes that there may be other aspects of the revised Directive which touch on the provision of key investor information, and for which further Level 3 measures may be desirable. CESR will not undertake any such work before delivering this advice to the Commission in October 2009.

*Transitional provisions*

Article 118 provides for a special transitional provision in relation to KII. A further 12 months after the implementation date of the measures is allowed for UCITS to replace their simplified prospectus with a KID. During that time, competent authorities must continue to accept the SP for both domestic and inwardly-passporting UCITS.

Although no implementing measures are provided for Article 118, some further consideration will be needed as to how this provision can be interpreted consistently. For example:

- Does it apply to new UCITS launched during the 12-month period, or must they use a KID from the outset?
- What about the launch of a new share class within an existing fund?
- Can an existing fund update its SP during the period or does the requirement to produce a KID take effect as soon as the current SP becomes out of date, for whatever reason?

It is suggested that these considerations should be addressed by CESR in the form of Level 3 guidelines in good time to assist management companies in the consistent implementation of the KID in 2010/11.

**Question for the CESR consultation**

*Do you agree with the approach to transitional provisions set out above?*

*Are there any other topics, relating to KII or use of a durable medium, not addressed by this consultation, for which CESR might undertake work on developing Level 3 guidelines?*

**Annex 1**

**Methodology for calculation of the synthetic risk and reward indicator**

Grid of fundamental requirements set out by CESR

1. As part of its work in Phase 1, CESR set out a grid of criteria that any calculation methodology and presentation of a synthetic risk and reward indicator should comply with. Based on this grid, the requirements are the following:

   - Applicability to as many funds as possible
   - Robust calculation methodology with no room for manipulation
   - Easy implementation by UCITS providers
   - Easy and effective supervision by the regulators
   - Stability and robustness of the categorisation against normal changes in the risk of capital markets
   - Clarity regarding limitations, in particular regarding the potential loss in the lowest classes and regarding potential loss in extreme adverse market circumstances
   - Clarity that categorisation does not imply any guarantee
   - As simple as possible to be user-friendly to and understandable by average investors

Background for the proposal

2. In its initial advice, CESR considered that an alternative option for risk and reward disclosures was a synthetic indicator. However, CESR acknowledged a common methodology was required to assign a risk category to each UCITS fund. In addition, CESR suggested that one single numeric scale, for all funds if possible, might be appropriate as it would be simple to understand and meaningful for investors (i.e. conveying the meaning of different categories in terms of potential gains or losses). Moreover, the indicator must not be misleading. In particular, it should allow investors to understand that low risk differs from no risk at all. Limitations to the overall accuracy of the indicator should also be exposed and should not be confusing for investors.

3. Findings from the Commission's testing exercise revealed that investors seem to be more confident in their ability to compare funds and assess their level of risk when they are provided with the synthetic risk indicator. It appeared also that their real level of understanding was not impacted.

4. In phase 2 of the Commission's testing, UCITS distributors also expressed a preference for the inclusion of a synthetic risk indicator in the KID.

5. In order to take forward the outstanding technical issues on risk and reward disclosures identified in its February 2008 advice, CESR established a specific drafting group composed of regulators and industry representatives. With a view to having an appropriate sample of industry experts, CESR requested EFAMA's assistance on identifying suitable individuals that would be willing to participate in the work. The association nominated four such experts with a broad range of industry experience; CESR then appointed these experts as members of the drafting group.

6. An initial proposal for a methodology underlying a synthetic risk indicator was consulted during a two-month period. The responses to the consultation show a general support for the idea of including a synthetic indicator in the KID. However there was a significant number of comments that were aimed at improving certain aspects of the proposed methodology, in particular in relation to structured funds.

7. The proposal below represents a revised version of the methodology that takes into account the results of phase 2 of the Commission's testing and the responses to the technical consultation. Numerous changes have been introduced in the proposal. CESR is very grateful for the significant contribution the experts' input has had in the formulation of its proposals.

The proposed methodology

8. The proposed methodology can be summarised as follows. The risk and reward profile of UCITS funds may be represented by calculating the volatility of the fund based on a series of investment returns (past performance) over an historical period of 3 to 5 years (3 years for funds with weekly returns, 5 years for funds with less frequent returns). However, two specific situations may arise that need to be addressed:

   - UCITS that have not been in existence long enough to generate the required length of time series; and

   - UCITS which have a markedly non-normal return distribution and for which the volatility of the return series may not adequately reflect the risk profile of the fund.

9. For funds with an insufficient history, the volatility used for categorisation will be calculated by combining the available performance history and the return series representative of the way the product would have behaved in the past. Very often, the benchmark or reference index of a fund can serve as a basis, but – depending on the fund type – other ways to arrive at a representative volatility will be necessary.

10. For funds with a markedly asymmetrical and hence non-normal distribution, the volatility of the investment returns may not convey an adequate image of the risk profile of the UCITS. In such cases, due to the asymmetrical nature of the return distribution, the risk of the fund would be best evaluated by looking specifically at the loss side of the return distribution. For this type of funds a VaR (Value at Risk) approach is envisaged in this proposal.

<u>A methodology that covers all UCITS types</u>

11. The proposed methodology makes an estimation of the risk profile of each fund that is tailored to the particular characteristics of the different types of UCITS. The fundamental idea is to use the historical volatility, or where applicable, the volatility based on VaR of the Fund's portfolio as a quantitative measure. Risk categories are then assigned by defining appropriate risk 'buckets'.

12. In this section we outline the proposed methodology for the indicator, with the choice of the risk measure and the general estimation methodology. In general, the aim is to establish a rules-based approach that provides a sufficiently uniform methodology for categorising comparable fund types.

<u>The choice of Risk Measure: Historical Volatility.</u>

13. The use of historical volatility can be justified by reference to the following:

    a) a well-known concept: volatility forms the cornerstone of Markowitz Portfolio Theory and is hence a well-known and well-established concept in the financial industry.

    b) a simple concept: as a measure of dispersion, volatility is conceptually easy to grasp.

    c) a comprehensive measure: it encompasses the risks to which the Net Asset Value (NAV) is exposed because, insofar as a fund's risk exposures cause fluctuations in its NAV, the fund's return volatility is increased (see also below).

    d) a computationally simple and unambiguous measure: volatility is a simple measure that can be estimated in a very straightforward and unambiguous way from a given historical return series. Because of its computational simplicity, the historical volatility estimate is therefore:

        i) easy for UCITS providers to implement;

        ii) robust and hence very difficult to manipulate abusively; and

        iii) easy for regulators to verify.

*Why historical volatility and not ex-ante volatility?*

14. The methodology proposes an ex-post measure of volatility, namely volatility measured over a certain historical period. This measure reflects past return dispersion and therefore it is important to note that this ex post measure is a descriptive, not a predictive, metric.

15. In an initial stage, the drafting group also considered the possibility of using ex-ante volatility, but this alternative was rejected mainly because of the potentially subjective nature of ex-ante volatility. In particular using ex can volatility would:

- require significant additional assumptions to be made, for example on the stochastic process that drives time-varying volatility;
- increase the computational complexity; and
- increase the cost of implementation for UCITS providers.

16. For these reasons, ex-ante volatility is not proposed as the basis for the methodology. In contrast, by prescribing precise rules for estimating historical volatility, a more objective approach can be brought to this measure.

*Is volatility a complete risk measure - what about risks other than market risk?*

17. At first sight, the risk measure may not appear suitable to capture all the risks to which a fund is exposed. However, if a sufficiently long time horizon is considered, then it is likely that the other risks to which a fund or its portfolio constituents is exposed (such as liquidity risk, counterparty risk) have materialised and affected the NAV. The impact on NAV in turn translates into fluctuations in returns and its hence reflected in the historical return volatility.

*Is volatility a complete risk measure - what about non-normal return distributions?*

18. Markowitz formalised the subjective notion of investment risk and operationalised the concept by means of the standard deviation. Markowitz' preferred choice was the semi-variance (or semi-standard deviation), taking into account only the (squared) deviations below the mean return. However, when return distributions are (approximately) symmetric, there is no meaningful difference between upside and downside dispersion, or between upside and downside volatility (semi-volatility).

19. It should be noted that in some funds the return distributions may be skewed over short observation intervals, e.g. daily. However, when increasing the observation interval to weekly and, notably, monthly periods, the distributions of returns on market funds tend to become symmetric – especially when considering large diversified portfolios.

20. However, given the great diversity of strategies and asset classes that are today permitted under the UCITS rules, there will still be certain funds where, even after increasing the observation interval, the distribution of returns will be markedly asymmetrical and hence non-normal. For such funds, an alternative approach for the computation of volatility based on Value at Risk (VaR), which focuses on the downside risk of the return distribution, is envisaged in this proposal.

<u>Estimation Methodology</u>

*The formula for volatility*

21. Using the standard statistical methods the volatility of a fund is taken to be:

$$\text{volatility( r[f] )} = \sigma_f = \sqrt{\frac{m}{T-1}\sum_{t=1}^{T}(r_{f,t} - \bar{r}_f)^2}$$

where the time-weighted fund returns $r_{f,t}$ are measured over T periods of 1/m years, and where $\bar{r}_f$ is the arithmetic mean of the fund return over the T periods:

$$\bar{r}_f = \frac{1}{T}\sum_{t=1}^{T} r_{f,t}$$

In this example, weekly returns are used so m=52.

*Length of time series and number of categories*

22. The question of the length of time series and of the number of categories must be considered simultaneously, since by fixing those parameters, the stability of the categorisation is determined.

23. In general terms, a highly adaptive estimator is not entirely desirable because:

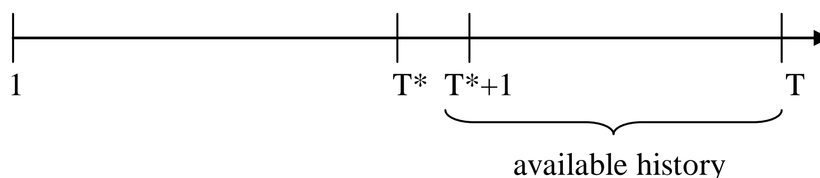
- the KID (and hence a fund's risk level) will not usually be revised more than once a year; and
- a fund could be classified as low risk when volatility levels are historically low and likely to increase over the (next) market cycle.

24. To accommodate (and in a way average out) the effect of market cycles on volatility, the methodology proposes to estimate volatilities over longer time periods. In particular, the proposed methodology is based on a time series of at least 3 to 5 years of weekly data and a 6-category scale.

25. The drafting group considers that such formulation creates an appropriate trade-off between the convenience of having a relatively stable scale, and the need to have a methodology that is sensitive enough to incorporate substantial changes in the Fund's risk profile.

Volatility estimation for new funds and funds with insufficient history

26. For new funds that lack sufficient data history, and for funds that have revised their investment policy substantially over the most recent T months, the methodology assumes that the relevant fund return history is available from periods T*+1 to T (most recent) :



27. The methodology further assumes that a representative index, portfolio mix or benchmark is identified for which returns over the period [1,T*] are available. The volatility of the fund should then be calculated according to the following procedure.

- take the T* returns of the identified representative index, portfolio mix or benchmark over the preceding periods 1 to T*
- take the T-T* available returns on the fund over the periods T*+1 to T
- chain-link (concatenate) both return series to one series over the full T periods
- estimate annualised historical volatility according to the general formula.

For funds where the NAV is calculated less frequently than on a weekly basis, it is proposed to calculate the annualised volatilities based on monthly data (m=12 in the above formula). The lower number of data points introduces a somewhat larger statistical uncertainty, but is clearly preferable to imposing a requirement to carry out more frequent valuations of those funds.

Application to different fund types

28. As laid out above, the general idea is to use the realised performance of a fund as far as possible to calculate volatility or VaR measure and thus determine the risk category. To make this idea work in practice, additional procedures need to be defined when there is no realised performance record (as for new funds) or the record is shorter than the required length of time series. There can also be cases where the historical return series is, with respect to volatility, not expected to be representative for the future returns of the fund.

29. This section explains how the methodology would assign a reliable volatility or VaR measure to different types of funds. This is designed to show that the proposed approach can be put into practice for the vast majority of fund products. It must be mentioned, however, that – when faced with a data history that is too short or not sufficiently representative – the exact method of filling the gap in the history will often depend on the individual features of the product. Thus the choice of methodology will often require some qualitative judgement and cannot be derived from a set of algorithmic rules. However, the UCITS operator should be able to justify its choice on the basis of the fund's investment policy, its representative asset mix, and potential changes to its risk profile. The following cases are to be viewed as examples of how certain fund types can be treated and not as proposals for mandatory decision requirements or for which approach to use under which conditions.

30. The methodology distinguishes three general types of fund:

    **Market funds**: Funds investing into fixed segments of the capital markets in such a fashion that their overall risk arises predominantly from the risk of the underlying market segments and their development over time, and less from the active investment decisions made by the portfolio manager. These are the 'classic' investment funds with a mostly static asset mix, including in particular funds managed closely against a benchmark.

**Strategy funds**: Funds managed such that their overall risk profile is not predominantly driven by the risk of fixed market segments but is determined by active allocation decisions made by the manager following a specific strategy. These funds have an actively-managed dynamic asset mix and include, in particular, absolute or total return funds. They also include the so-called life cycle funds, where the asset mix – and thus the risk profile – changes significantly but quite predictably over time.

**Structured funds (including guaranteed funds)**: Funds that provide investors with formula-based (contingent) payout profiles, linked to market indices or asset mixes, and often provide protection from the full impact of market volatility. Depending on the level of the underlying index or mix, the risk profile of the fund will change. Examples of these funds are capital protected funds, guaranteed products and 'floor' products.

31. The application of the methodology to the different types of fund identified above is described in the following sections.

***Market Funds***

32. A market fund invests into fixed segments of the capital markets and (provided there are no changes in investment policy) its portfolio holdings can largely be characterised as a 'static mix'. When allowing limited room for active management, funds can be characterised as 'static mix plus'. This implies that the manager can indicate a reference index or asset mix that is representative for the fund's stated investment policy, or a benchmark against which the fund is managed.

33. The methodology for estimating the risk measure in market funds is:

- when full T-period return history is available and the fund's investment policy has not been revised during this period, estimate the annualised volatility according to the general formula
- for new funds that lack sufficient data history, and for funds that have revised their investment policy substantially over the most recent T periods:
  - i) take the relevant available fund return history
  - ii) identify the fund's representative index, portfolio mix or benchmark ('proxy')
  - iii) chain-link (concatenate) both return series to one series over the full T periods
  - iv) estimate annualised historical volatility according to the general formula.

Note 1: For newly launched funds or funds that have recently revised their investment policy, there is no relevant history and the volatility is based completely on the return series of their proxy.

Note 2: The above procedure can also be followed when the available fund return history is not deemed representative for the current composition of the fund's portfolio.

***Strategy Funds***

These funds are managed so that their overall risk profile is largely determined by (active) allocation decisions made by the manager following a specific strategy. Since their investment policy allows these funds to change their portfolio holdings substantially over time, these funds can be characterised as 'dynamic mix'. Within this class, we distinguish between (1) absolute return funds, (2) total return funds, and (3) life cycle/target maturity funds.

*(1) Absolute return funds*

34. These funds aim to generate positive returns over an implicit or explicit cash benchmark by employing active strategies, and are likely to use long / short derivative positions. Because of the cash benchmark and the long / short decisions, there is no index or asset mix representative for their portfolio holdings. From the active and dynamic nature of their allocation decisions, these funds can be characterised as 'active dynamic mix'.

35. Many of these funds will be managed in line with a risk limit (in the form of a volatility or exposure limit) or the manager will be able to specify a target volatility. Even when this ex-ante risk 'budget' has not been used by the manager in the past (or the target volatility has not been reached in the past), the manager is allowed to do so under the prevailing investment policy. This suggests taking the maximum of the realised volatility and the volatility limit as the relevant volatility estimate for this type of fund.

36. The methodology for estimating the risk measure in Absolute return funds is:

- when full T-period return history is available, take the maximum of
  - (a) the actual historical volatility and
  - (b) the volatility risk limit or the target volatility of the fund
- for new funds that lack sufficient data history, and for funds that have revised their investment policy substantially over the most recent T periods, take (b) above

37. When the risk limit is not available in the form of a volatility limit but instead as a VaR limit or an exposure limit, an approximation of the volatility that is required for classifying the corresponding strategy fund can be derived as follow.

For example, for a 1 year and a 95% confidence level, the VaR is defined by the 5% quantile of fund returns measured from the expected return one year hence. When the return distribution would be normal, this quantile is 1.65 times the standard deviation and the VaR equals :

VaR = 1.65 * volatility – expected return
= 1.65 * volatility – ( risk free rate + risk premium)

Solving for the volatility:
volatility = ( VaR + risk free rate + risk premium ) / 1.65
= ( VaR + risk free rate ) / 1.65 + risk premium / 1.65
≈ ( VaR + risk free rate ) / 1.65

*38.* This is an 'optimistic' estimate of the volatility, but the difference with the actual implied volatility is only about half of the risk premium – this latter error term will be relatively small. For VaR limits with higher confidence levels, the error term will be even smaller.

*(2) Total return funds*

39. These funds aim to maximise total return relative to a benchmark by participating in rising equity and fixed-income markets. Within their investment policy, and according to market dynamics and the manager's views, the allocation across assets and asset classes may change rapidly. A risk limit or target volatility may or may not be available. From the active and dynamic nature of their allocation decisions, these funds can also be characterised as 'active dynamic mix'.

40. The methodology for estimating the risk measure in total returns funds is:

- when full T-period return history is available and limit / target volatility exists, take the maximum of

  (a) the actual historical volatility

  (b) the volatility of the pro-forma asset mix that is consistent with and representative of the fund's investment policy and

  (c) the risk limit or target volatility of the fund

- for new funds that lack sufficient data history, and for funds that have revised their investment policy substantially over the most recent T periods, take the maximum of (b) and (c) above.

*(3) Life cycle / target maturity funds*

41. The fund's asset allocation changes over time and tends to become more defensive as the target date approaches. Since the target allocation within the fund changes over time, not all of its return history may be representative of the current asset allocation. Since the allocation of these funds does change (gradually) over time, but not because of active (i.e. view-based) management, they can be characterised as 'passive dynamic mix'.

42. The methodology for estimating the risk measure in Life cycle / target maturity fund is:

- when full T-period return history is available and the fund has not changed its target asset mix over this full period, take the actual historical volatility;

- for new funds that lack sufficient data history, and for funds that have revised their (target) allocation substantially over the most recent T periods:

  i) take the maximum relevant fund return history

  ii) identify the fund's current (mix of ) representative index(es)

  iii) combine both return series to estimate volatility, as outlined above

***Structured Funds (including guaranteed funds)***

43. These funds provide investors with formula-based (contingent) payout profiles, linked to market indices or asset mixes, and often provide protection from the full impact of market volatility. Depending on the level of the underlying index or mix, the risk profile of the fund will change. Examples of these funds are capital protected funds, guaranteed products and 'floor' products.

44. Depending on market dynamics, the structured fund allocation (and hence its risk profile) can change quite quickly and drastically. It is also worth mentioning that many of these funds make use of non-linear derivatives and hence have a markedly asymmetrical return distribution.

45. In addition, structured funds present the particular circumstance that most investors buy the product and hold it until maturity. As a result, the relevant risk for the majority of investors is not a short term risk, but the risk of obtaining a potential loss when holding the fund until maturity. Taking this into account, the risk categorization of this type of funds could be initially accommodated by looking at the potential return distribution of the fund at maturity.

46. However, it should also be noted that structured funds that follow within the remit of current CESR work on the synthetic risk indicator must remain open for redemptions at any time (as mandated by the UCITS Directive), hence, the relevant risk for investors cannot be only represented by assuming that the investor will hold the fund until maturity. UCITS funds, in fact, are generally distributed among retail investors also on grounds of their widespread reputation as liquid investments.

47. As a consequence, the methodology envisages that the risk categorization of structured funds should be calculated by taking the maximum of:

    (a) the 95% VaR at maturity.

    (b) the 95% VaR in a 1 year time.

    The maximum of both metrics will be then expressed as the corresponding 1 year volatility and classified accordingly into the risk scale.

48. In order to compute the return distributions, the methodology envisages the use of a historical simulation approach. In particular, the 95% VaR should be estimated by using a data sample of 5 years and weekly observations. Therefore, the fund risk

profile will be estimated by looking at the performance of the formula-based payoff under different market conditions.

49. However, the methodology above assumes, where applicable, that the counterparty of OTC derivatives and/or the guarantor of the fund will not fail to perform their obligations. As this is not always the case, the possibility of such failure should be taken into consideration when computing the return distribution. The probability of these counterparties defaulting can be easily computed with a standardized approach by looking at the market price of traded instruments such as Credit Default Swaps and corporate bonds.

50. The proposed methodology provides for a risk measurement that is tailored to cover the particular circumstances of structured funds. At the same time, it also provides a rule-based approach for grading the funds that can be easily incorporated in the 6-category scale.

External monitoring of the categorisation of a fund

51. For all funds with a sufficiently long performance history, the ongoing validation of the risk categorisation is a straightforward exercise based only on publicly available performance data.

52. If the categorisation of recently-launched or brand-new funds is to be validated before they have collected a sufficient performance history, external validation will require an assessment of whether the available realised volatility is, under the then prevailing market conditions, consistent with the given category. This inevitably requires a somewhat qualitative assessment, whoever the monitoring party may be.

53. Even if the monitoring process were to go into more detail by validating the choice of index or volatility limit that was initially used for categorisation, a qualitative assessment would still be needed. For market funds with linear investments that might be a simple task, but for more complex products it could be more challenging.

Merits and drawbacks of the methodology

54. The methodology presents several merits. It is relatively simple. It is capable of covering all UCITS types and works for the most sophisticated products. The methodology is easy for the asset management industry to implement; and easy for regulators to verify as it is difficult to manipulate abusively.

55. In addition, the metrics chosen (volatility, as also computed from VaR), presents many merits as objective measures of a fund's risk and reward profile. Both concepts are well-known in the asset management and broader financial industry and are easy to grasp. In addition, both metrics encompasses most of the fund's risk exposures since those exposures contribute to the fluctuations in a fund's NAV.

56. However, implementation of the methodology might lead to higher costs for UCITS providers, although tools might be made available to address this.

Presentation

57. The final sections of this chapter address the presentation of the risk indicator, including the type of the scale (use of wording, colours, numbers etc.), how to present the scale, and what disclaimers should accompany the indicator.

*The scale*

58. The scale of risk categories should be numeric and a full scale from 1 to 6 should be shown. The number of boxes is predefined by the results of the methodology. No colours are used, although a grey-scale shading may be used for the box containing the assigned category, as in the following examples.

| **Example of return distribution fund that would fall into category 2:** | Graphic or visual explanations Risk and reward scale chart | ⇦ **Typically lower rewards** **Typically higher rewards** ⇨<br>⇦ **Lower risk** **Higher risk** ⇨ | | | | | |
|---|---|---|---|---|---|---|---|
| | | 1 | **2** | 3 | 4 | 5 | 6 |

59. If CESR decides, in the light of feedback from this consultation and the Commission's consumer testing, to proceed with a recommendation to adopt the methodology set out in this chapter, some further development and refinement of the proposal will be needed. One of the points that CESR is to address is how the results of the volatility, as also computed, where applicable, from the VaR measure, should be distributed among the risk 'buckets'.

<u>Disclaimers and explanations that should accompany a synthetic risk and reward indicator</u>

60. CESR recommends that the synthetic indicator should be accompanied by a narrative description that explain the approach takes, and if applicable, if limitations:

61. Taking into account the objective of keeping the KID no longer than two pages, CESR recommends that only the following items should be addressed:

- historical data is not a reliable indication for the future;
- the risk category of a fund is not a target or guarantee and may shift over time;
- the lowest category does not mean a risk-free investment;
- why the fund is in a specific category;

- details of the nature, timing and extent of any capital guarantee or protection, including the potential effects of redeeming the investment outside the guaranteed or protected period.

**Annex 2**

**Methodology for calculation of the ongoing charges figure**

The management company of the UCITS is responsible for the calculation of the ongoing charges figure and for its accurate statement in the KID. The management company must establish procedures that are consistent with this methodology and are adequately documented. Records of each calculation must be kept for a period of 5 years after the last date on which that version of the KID was available to be issued.

*Definition of ongoing charges to be disclosed*

1. In the context of the KID, 'ongoing charges' are payments deducted from the assets of a UCITS where such deductions are required or permitted by national law and regulation, the fund rules or instrument of incorporation of the UCITS, or its prospectus. The figure to be disclosed in the KID is based on the total of all such payments made over a specific period, excluding the exceptions identified below.

2. The ongoing charges should include all types of cost borne by the UCITS, whether they represent expenses necessarily incurred in its operation, or the remuneration of any party connected with it or providing services to it. These costs may be expressed or calculated in a variety of ways (e.g. a flat fee, a proportion of assets, a charge per transaction, etc).

3. The following list is indicative but not exhaustive of the types of ongoing charge that, if they are passed as debits through the profit and loss account of a UCITS, should be taken into account in the amount to be disclosed:

- All payments to
  - the operator of the UCITS
  - directors of the UCITS if an investment company
  - the depositary
  - the custodian(s)
  - any investment adviser;
- All payments to any person providing outsourced services to any of the above, including:
  - providers of valuation and fund accounting services
  - shareholder service providers, such as the transfer agent and broker dealers that are record owners of the UCITS' shares and provide sub-accounting services to the beneficial owners of those shares;
- Registration fees, regulatory fees and similar charges;
- Audit fees;
- Payments to legal and professional advisers;
- Any costs of distribution.

4. The following charges and payments do not form part of the amount to be disclosed as ongoing charges in the KID:

- Entry/exit charges or commissions, or any other amount paid directly by the investor;
- A performance-related fee payable to the operator or any investment adviser;

- Interest on borrowing;
- Payments necessarily incurred in connection with the acquisition or disposal of any asset for the UCITS' portfolio, whether these payments are explicit (e.g. brokerage charges, taxes and linked charges) or implicit (e.g. costs of dealing in fixed-interest securities, market impact costs);
- Payments incurred for the holding of financial derivative instruments (e.g. margin calls);
- The value of goods or services received by the operator or any connected party in exchange for placing of dealing orders (soft commissions or any similar arrangement).

5. The exclusion for transaction-related costs does not extend to transaction-based payments made to the operator, depositary or custodian, or anyone acting on their behalf, for which the recipient is not accountable to the UCITS; all such amounts must be taken into account in the disclosure figure.

6. Under a fee-sharing agreement, the management company or another party may be meeting, all or in part, costs that should normally be included in the ongoing charges disclosure. They should therefore be taken into account by adding to the total ongoing charges disclosure any remuneration of the management company (or another party) that derives from such fee-sharing agreements. However, there is no need to take into account fee-sharing agreements on expenses that are already accounted for in the ongoing charges disclosure. Thus:

- the remuneration of a management company through a fee-sharing agreement with a broker on transaction costs, or with a custodian on stock-lending income, or with other management companies in the case of a fund of funds, should be taken into account in the disclosure figure;
- conversely, the remuneration of a management company through a fee-sharing agreement with a fund (except for the specific fund of funds case mentioned above) need not be taken into account.

7. Where a UCITS invests a substantial proportion of its assets in other UCITS or collective investment undertakings (CIUs), and so makes the disclosures required by Article 55(3) of the UCITS Directive, its ongoing charges figure should take account of the ongoing charges incurred in the underlying CIUs, to the extent that it is possible to do so accurately. The following should be included in the calculation:

a) if the underlying CIU is a UCITS (or a non-harmonised CIU which elects to comply with the KID disclosure requirements) its most recently available ongoing charges figure should be used; this may be the figure published by the CIU or its operator, or a figure calculated by a reliable third-party source if more up-to-date than the published figure;
b) if the underlying CIU is operated by the UCITS operator or an entity within the same group as the UCITS operator, but does not fall within (a), the UCITS operator should make a best estimate of its ongoing charges following the methodology applicable to UCITS funds;
c) if the underlying CIU is operated by a third party and does not publish an ongoing charges figure, the UCITS operator should use any published information which represents a reasonable substitute for that figure (e.g. a total expense ratio published by a reliable source) or else should make a best estimate of its maximum

level based on scrutiny of the CIU's current prospectus and most recently published report and accounts;

d) where CIUs falling within (c) represent less than 15% of the UCITS' assets, it is sufficient to use the published annual management charge for those CIUs instead of estimating their ongoing charges;
e) in all cases, the ongoing charges figure may be reduced to the extent that there is any arrangement for the investing UCITS to receive a rebate or retrocession of charges from the underlying CIU (if this is not already reflected in the fund's profit and loss account);
f) any subscription and / or redemption fees payable in relation to the underlying CIU should be regarded as transaction charges and need not be taken into account in the calculation of the ongoing charges figure.

8. In the case of an umbrella fund, each constituent sub-fund should be treated separately for the purpose of this section, but any charges attributable to the umbrella as a whole should be apportioned among all of the sub-funds on a basis that is fair to all investors.

*Methodology for calculation (except for new funds)*

9. The ongoing charges figure should be expressed as the ration of the total discloseable costs to the average net assets of the UCITS, calculated according to this section. The figure should be expressed as a percentage to two decimal places.

10. As provided for in section 6, the ongoing charges figure is calculated at least once a year, on a ex-post basis, generally with reference to the last audited annual accounting period of the UCITS. Where it is considered unsuitable to use the ex-post figure because of a material change (e.g. an increase in management fees), an estimate may be used instead until audited ex-post figures reflecting the material change are available.

11. A separate calculation should be performed for each share class, but if the units of two or more classes rank pari passu, a single calculation may be performed for them (see also section 10 on the use of a representative class).

12. Wherever possible, the costs shown should be those set out in the UCITS' statement of operations for the relevant accounting year. They are assessed on an 'all taxes include' basis, which means that the gross value of expenses should be used.

13. The average net assets should relate to the same period as the costs, and be calculated using figures based on the UCITS' net assets at each calculation of the NAV (e.g. daily NAVs where this is the normal frequency of calculation approved by the UCITS competent authority).

14. Where the ongoing charges attributable to an underlying CIU are to be taken into account:

a) The ongoing charges figure (or equivalent) of each underlying CIU is pro-rated according to the proportion of the UCITS's net asset value which that CIU represents at the relevant date (being the date of the accounts from which the UCITS figures are taken);

b) all the pro-rated figures are added to the ongoing charges figure of the investing UCITS itself, thus presenting a single total (a 'synthetic' ongoing charges figure).

15. Where the competent authority interprets the UCITS Directive as permitting the annual account period of a UCITS to be extended beyond 12 months, the competent authority may determine when the calculation should be performed in such cases.

16. Information about the ongoing charges figures for previous years / periods should be published at the location (e.g. the operator's website) which is specified in the KID as the general source of further information for investors who require it.

*Methodology for calculation for new funds*

17. The same methodology would apply as for an ex-post calculation, subject to the following points:

- Figures need not be shown to two decimal places if, in the operator's opinion, to do so would suggest a spurious degree of accuracy;
- It should be assumed that no rebates or fee waivers will be received to the benefit of the fund unless these have been disclosed in the prospectus.

18. Where an estimated figure is disclosed for a new fund, the operator need not calculate an actual figure on an ex-post basis until 12 months after the date on which units are first offered for sale, or until the end of the first annual accounting period if later. If the actual figure differs materially from the estimate, the KID should be updated accordingly.

# Annex 3

## Methodology for calculation of a summary charges figure

**Illustration in cash terms**

The following may be considered as a starting point for standardised disclosure of charges in cash terms:

- Select a rate of return for the fund.
- Assume a single investment at the start of the period of [€]1,000.
- Assume that all of the charges and expenses disclosed within the KID (other than performance fees, and entry charges if they are applied when reinvesting dividend income) apply and remain the same throughout the period being illustrated.
- Entry and exit charges should be included at the maximum level and applied on the basis that all units are acquired at the beginning of the period being shown and redeemed at the end of the period being shown.
- Assume reinvestment of all income (dividends or distribution).
- Should a fund have a minimum investment greater than [€] 1,000, then a narrative statement should be included that the minimum investment is greater than the amount being illustrated.
- The currency shown should be that of the fund or share class described in the KID but a host Member State may not require funds being sold cross-border to convert the presentation to the local currency of that State.

**Annex 4**

**Methodology for calculation of a probability table for a structured fund**

*Methodology for computing probabilities*

To compute the simulations needed to quantify the probabilities of the performance scenarios, it is desirable to establish a set of binding, but still sufficiently flexible, methodological requirements, which translate general principles of correctness, accuracy and prudence regarding the outcome of the disclosure. Such requirements allow for the use and implementation of a large array of models and computational techniques, that are broadly reflected within the pricing, hedging and general risk management processes and systems adopted by most asset management companies.

The following steps would be required to apply the methodology outlined above:

i) Identify the underlying financial variables and techniques that are relevant to the investment strategy adopted by the fund.

ii) Define the processes that are assumed to govern the evolution of the variables identified at the previous step, and calibrate their parameters.

Models should be identified and calibrated with due regard to the pricing, hedging and general risk management processes and systems employed by fund management companies. This will not only enable synergies of costs and expertise (economies of scope) to be achieved, but should ensure that the accuracy of the disclosure is maintained over time because of a true matching with the characteristics of the fund, and as a result of a solid integration with management, pricing and control structures and procedures.

iii) Simulate the performances of the fund over the appropriate (often pre-determined by the formula/algorithm) investment horizon and under the risk-neutral measure.

Fund performances should be simulated taking a risk-neutral approach. This approach offers clear advantages from both a regulatory and a supervisory perspective, as it meets a general criterion of prudence with respect to the simulations of the performances of the fund and does not require data for the average returns of assets (that is, it avoids the issues linked to the equity 'risk-premium'), whose estimates may widely differ according to the sample period being analysed or to the subjective judgment of those who perform the simulation.

Furthermore, the adoption of a methodology based on risk-neutrality appears perfectly consistent with the pricing and hedging tools ordinarily used by asset management companies and, in general, by financial intermediaries in their proprietary activities. In conclusion, the adoption of a risk-neutral perspective is justified by the same nature and objective of the content disclosed in the table, which represents only an alternative, equivalent and more complete representation of the information contained in the price of these products at the time of their offering.

iv) Simulate the returns from investments in risk-free assets over the same holding period of the fund as was identified according to the previous step.

The distribution of risk-free returns at the end of the holding period of the fund should be simulated in the same way, as risk-free rates are also subject to movements that can be modelled as stochastic processes.

To calibrate these processes, relevant parameters would need to be set at values which, at least, should be consistent with those applied to the models used for simulating the performances of the fund.

In particular, it should be noted how the elaboration of the estimated risk-free rate into the computation of the fund's performance at each step of the simulation may represent a very effective solution to address the difficulty of capturing the correlation between the equity and the interest rate risk factors.

v) Perform a probabilistic comparison of the possible performances of the fund with the returns that could be achieved by investing over the same holding period in risk-free assets.

As already explained, the distributions of fund performances and of risk-free returns are compared by means of three scenarios (events), where the risk-free returns play the role of terms of reference to classify the performances predicted for the fund.

*Example of presentation of probability tables*

The three performance scenarios are illustrated in the table below.

**Example of a probability table**

| EVENTS | PROBABILITY |
|---|---|
| The performance of the fund is negative | **10 %** |
| The performance of the fund is positive but lower than the return from an investment in risk free assets over the same time horizon of the fund | **20 %** |
| The performance of the fund is positive and in line with the return from an investment in risk free assets over the same time horizon of the fund | **40 %** |
| The performance of the fund is positive and higher than the return from an investment in risk free assets over the same time horizon of the fund | **30 %** |