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CONSULTATION PAPER

CESR's level 3 guidelines on the selection and presentation of performance scenarios in the Key Investor Information document (KII) for structured UCITS

Deadline for contributions: CESR invites responses to this consultation paper by 10 September 2010. 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.

Introduction

The revised UCITS Directive (2009/65/EU)[1], which must be implemented in all Member States by 1 July 2011, requires, for structured UCITS (including capital-protected and guaranteed UCITS) and other comparable UCITS, the use of prospective scenarios as presentation of past performance is not relevant[2].

Article 36 of the Commission Regulation No 583/2010 implementing the Directive as regards key investor information (KII) provides that:

1. *"The [key investor information document] for structured UCITS shall not contain the "Past performance" section.*

   For the purposes of this Section, structured UCITS shall be understood as UCITS which provide investors, at certain predetermined dates, with algorithm-based payoffs that are linked to the performance or to the realization of price changes or other conditions, of financial assets, indices or reference portfolios or UCITS with similar features.

2. *For structured UCITS, the section entitled "objectives and investment policy" of the [key investor information document] shall include an explanation of how the formula works or how the pay-off is calculated.*

3. *The explanation referred to in paragraph 2 shall be accompanied by an illustration, showing at least three scenarios of the UCITS' potential performance. Appropriate scenarios shall be chosen to show the circumstances in which the formula may generate a low, a medium or a high return, including, where applicable, a negative return for the investor.*

4. *The scenarios referred to in paragraph 3 shall enable the investor to understand fully all the effects of the calculation mechanism embedded in the formula.*

   They shall be presented in a way that is fair, clear and not misleading, and that is likely to be understood by the average retail investor. In particular, they shall not artificially magnify the importance of the final performance of the UCITS.

5. *The scenarios referred to in paragraph 3 shall be based on reasonable and conservative assumptions about future market conditions and price movements.*

   However, whenever the formula exposes investors to the possibility of substantial losses, such as a capital guarantee that functions only under certain circumstances, these losses shall be appropriately illustrated, even if the probability of the corresponding market conditions is low.

6. *The scenarios referred to in paragraph 3 shall be accompanied by a statement that they are examples that are included to illustrate the formula, and do not represent a forecast of what might happen. It shall be made clear that the scenarios shown may not have an equal probability of occurrence".*

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[1] which was formally adopted by the Council on 22 June 2009 and published in the official journal on 17 November 2009.

[2] Article 78 (3) provides that:
"Key investor information shall provide information on the following essentials elements in respect of the UCITS concerned:
[…]
(c) past performance presentation or, where relevant, performance scenarios ;
[…]"

In order to ensure comparability between structured UCITS, the consistency in the choice of prospective scenarios and the format of the presentation of those scenarios, CESR has developed guidelines with a view to harmonising the selection and presentation of scenarios.

References to a UCITS in the guidelines should be read as applying to each compartment of a UCITS umbrella structure. All references to a management company in the guidelines should be read as applying to an investment company that has not designated a management company.

Guidelines

Box 1

Definition

These guidelines apply to structured UCITS authorised under Directive 2009/65/EC which shall be understood as UCITS which provide investors, at certain predetermined dates, with algorithm-based payoffs that are linked to the performance, or to the realization of price changes or other conditions, of financial assets, indices or reference portfolios or UCITS with similar features.

Explanatory text

1. The definition of structured UCITS for the purposes of the KII is based on the definition provided by the European Commission in article 36 of the Commission Regulation for KII. This includes certain types of capital-protected and guaranteed UCITS. These UCITS can have a risk profile that is difficult to understand; consequently, the use of tables or graphs should help investors to understand the UCITS' strategy.

Box 2

Choice of the scenarios

1. When selecting, presenting and explaining the scenarios, management companies shall follow the overriding principle that the information is fair, clear and not misleading.

2. Management companies shall choose at least three scenarios of the UCITS' potential performance to illustrate how the payout works under different market conditions.

3. The scenarios shall illustrate:
   - the functioning of the formula in unfavourable, favourable and medium market conditions;
   - specific features of the formula, for instance a capped performance, or a level of leverage;
   - situations where some mechanisms of the formula have a favourable or unfavourable impact on final performance.

   Depending upon the formula, more than three scenarios may be required to adequately describe the possible range of outcomes.

4. The examples used in favourable and unfavourable scenarios shall be based on reasonable assumptions about future market conditions and price movements.

5. The unfavourable scenario shall always be explained first.

6. The selected scenarios shall have a narrative explanation of the advantages and drawbacks of the formula where these are not included in the *Risk and reward* section.

7. The scenarios shall represent information which is complementary to and consistent with the information in other sections of the KII.

Explanatory text

2. The scenarios should illustrate how a structured UCITS will work under different market conditions. An investor can then gain a better understanding of the merits and limits of a UCITS when provided with answers to 'what if?' questions.

3. The example scenarios show how the formula calculates the final payoff of the fund under unfavourable, favourable, and medium market conditions as well as illustrating any special features of the formula.

4. The choice of scenarios should be appropriate to the characteristics of the UCITS. It should include any market situations that could have a particularly negative impact on the final payoff so that an investor could suffer substantial losses. This is likely to require a fourth scenario to show how extreme market conditions (which an average investor might not otherwise consider) could breach any conditional protection mechanism.

5. The chosen scenarios shall give a balanced presentation of the positive and negative aspects of the formula. The favourable scenarios shall not be based on unreasonably optimistic assumptions of future market conditions, so that the growth potential of the fund is not exaggerated.

Questions for the consultation

1. Do you agree with the proposals in Box 2?
2. Are there any other scenarios which these guidelines should address?

Box 3

Presentation of the scenarios

1. The scenarios shall be called *Illustrative examples*. The narrative shall make it clear that they are not forecasts and that they are not equally probable.

2. Each set of scenarios shall be presented as either tables or graphs, whichever is the clearer way to present the characteristics of each structured UCITS. See the Annex for examples.

3. The illustrative returns in the various scenarios shall be displayed as an annualised rate of growth (with an appropriate explanation). However, the [capitalised/gross] rate of growth may also be shown.

4. To ensure the comprehensibility and the comparability of different graphs, the presentation shall avoid:
   - double scales (left and right) whenever possible;
   - artificially magnifying the positive aspects of the fund payout;
   - non-linear scales;
   - different scales depending on the scenario.

5. The narrative shall explain that investors can sell their units before the end date but it must include a prominent warning of the possible resulting loss on the investment.

Explanatory text

6. Regarding the presentation, the scenarios should be called 'illustrative examples' to indicate that they are not forecasts. This should also be emphasised in the explanatory narrative.

7. CESR believes that management companies are best placed to decide between tables or graphs. There should be a separate graph or table for each scenario.

   - Tables may be appropriate when the investment strategy and the formula for the payout is easy to explain or when the payout depends on the performance of a basket of shares.

   - Graphs may be appropriate where a table becomes complicated or where the payout cannot be properly illustrated. For instance, UCITS based on a path-dependent payout, or one based on the average performance over time of an index.

8. The narrative shall explain that investors can sell their units before the end date. However, it shall also include a prominent warning of the possible resultant loss on the investment because the value will not be calculated using the formula but will depend on the market value of the underlying assets at that time.

9. Since structured UCITS have extremely varied risk and reward profiles, these guidelines cannot address all potential situations. For instance, where the formula averages the performance of underlying assets such as indices or shares, the fund's growth or loss is generally limited. In this situation, the narrative should clearly explain that the investor will not receive the full benefit of the growth in the underlying nor suffer the full loss of the decline in the underlying.

Questions for the consultation

3. Do you agree with the proposals in Box 3?

4. Is there any other guidance which should be given about the presentation of scenarios?

ANNEX

Examples of scenario selection and presentation

These examples are designed only to illustrate these guidelines; they should not be taken as templates for the design of KII documents.

Choice of scenarios

Example A

A fund indexed to the average performance of a benchmark will require scenarios illustrating:
- the payout under favourable conditions;
- the positive impact of the formula if the benchmark declines at the end of the fund's life; and
- the negative impact if the benchmark performs strongly near the end date.

Use of tables

Example B

Illustrative tables may be the most appropriate for a structured UCITS with a payoff based on the average performance of a basket of shares over time. For instance, a UCITS with an investment strategy to achieve a payoff based on the yearly performance of a basket of 5 shares calculated over 2 years.

The final payoff is the average of all the performances of each share in the basket. The performance is calculated as the underlying value of each share in the basket after 2 years with any growth capped at 9.5%. There is a legally enforceable guarantee of the return of the amount invested.

Unfavourable scenario:

Share	Underlying performance	UCITS performance
1	-4%	-4.0%
2	-2%	-2.0%
3	-12%	-12.0%
4	-23%	-23.0%
5	0%	0.0%

Average performance of the basket of shares	-8.2%
UCITS performance	0%
Equivalent annual growth rate	0%

At the end date, the average performance of the basket is -8.2%, so the guarantee will apply.

If units are sold before the end date: the price will not be calculated using the formula but will be based on the net asset value of the UCITS which will include the market value of the financial derivative instruments used.

Favourable scenario:

Share	Underlying performance	UCITS performance
1	10%	9.5%
2	11%	9.5%
3	12%	9.5%
4	10%	9.5%
5	13%	9.5%

Basket of shares performance	11.2%
UCITS performance	9.5%
Equivalent annual growth rate	4.65%

Therefore, an investment kept until the end date would pay out only 9.5% of the amount invested.

Medium scenario:

Share	Performance	Performance Retained
1	2%	2.0%
2	0	0.0%
3	8%	8.0%
4	-5%	-5.0%
5	11%	9.5%

Basket of shares performance	3.2%
UCITS performance	2.9%
Equivalent annual growth rate	1.44%

At the end date, the average performance of the basket is 3.2%, and the UCITS performance will be only 2.9% because of the cap on one of the shares in the basket. This corresponds to an annual growth rate of 1.44%.

In these scenarios it would be difficult to use several graphs for each share in the basket and also to illustrate the final payout by the UCITS.

Use of graphs

Example C

For a structured UCITS designed to last for up to 8 years, but with an early 'kick-out' feature.

If at an annual measurement date, Eurostoxx is at least at its level on the start date, the payout is the original investment increased by 8% for each of the years since the start date. If this happens at the end of the second year onwards, the equivalent annual growth rate will be less than 8%.

If at each annual measurement date, the performance of the Eurostoxx index remains below its level at the start date, the payout after 8 years depends on the CAC 40 index.

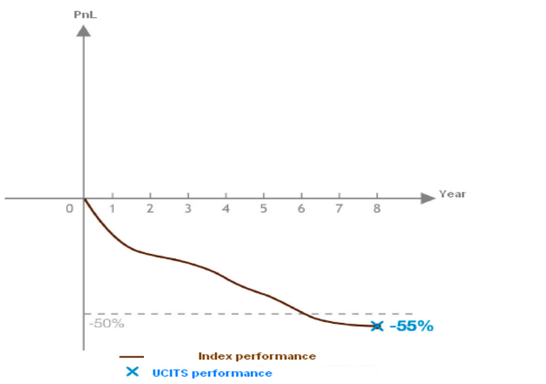
- If the CAC 40 index has dropped by 50% or less since the start date, the original investment is paid back.
- If the CAC 40 index has dropped by more than 50% since the start date, the payout is the amount originally invested reduced by the percentage decrease in the Eurostoxx index.

Investors' capital is therefore at risk.

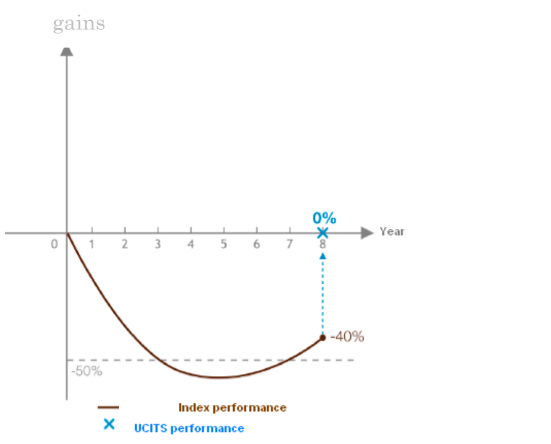
Very unfavourable scenario:

The Eurostoxx index remains below the level at the start for 8 years so the plan does not pay out early.

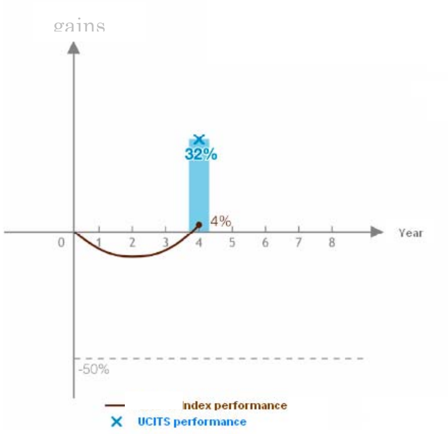
After 8 years, the level of the CAC 40 index is less than 50% of its level at the start date, which means that the payout is less than the amount originally invested.



Unfavourable scenario:

The Eurostoxx index remains below the level at the start for 8 years so the plan does not pay out early. But after 8 years the CAC 40 index has not reduced by more than 50% of its level at the start, so the payout is the amount originally invested.	

Favourable scenario:

The Eurostoxx index goes above its level at the start date for the first time at the 4th measurement date. The plan will then pay out the original investment plus 32% (4 x 8%), so a €1,000 investment would grow to €1320. The equivalent annual growth rate would then be 7.18%.	

If units are sold before the end date: the price will not be calculated using the formula but will be based on the net asset value of the UCITS which will include the market value of the financial derivative instruments used.