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FEEDBACK STATEMENT

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



Executive Summary

In this document CESR gives feedback on the responses received to the consultation on level 3 guidelines on the selection and presentation of performance scenarios in the Key Investor Information document for structured UCITS (Ref. CESR/10-530) published in July 2010.

The main changes made to the guidelines involve additional clarification on the circumstances in which the scenarios should be updated, as well as clarifying the link between the outcome from the investor's perspective and the market conditions.

The final guidelines (Ref. CESR/10-1318) are being published alongside this feedback statement.



Background

1. CESR published a consultation on level 3 guidelines on the selection and presentation of performance scenarios in the Key Investor Information document (KII) for structured UCITS (Ref. CESR/10-530) on 20 July 2010. CESR received a total of 23 responses by the deadline of 10 September. Responses were from a range of stakeholders including firms and associations representing the asset management, banking and insurance sectors, as well as retail investor representatives and academics. A list of non-confidential respondents to the consultation is included in Annex 1.

General comments

2. Respondents raised a number of general comments.
3. Retail investor and academic representatives were of the view that the scenarios may convey a misleading impression if they are not accompanied by an explicit assessment of the likelihood (i.e. probability) attached to each scenario. They felt that the lack of any indication of probability gave intermediaries too much discretion to develop potentially misleading scenarios and that it would have been preferable to introduce a harmonised set of quantitative criteria to support the scenarios. They took the view that such a probability table could be based on the VaR-at-maturity approach set out in the methodology for the synthetic risk and reward indicator (SRRI). The same respondents felt that a new consumer testing exercise should be carried out in order to compare the merits of the competing approaches. In direct contrast, one trade association felt that indicating an exact level of probability could confuse investors and may lead them to interpret the scenarios as forecasts rather than illustrative examples.
4. One stakeholder stated that the overriding requirement should be for information to be fair, clear and not misleading.
5. It was stated by one respondent that a narrative explanation of the advantages and drawbacks of the formula should be included in both the risk and reward and performance scenarios sections.
6. One respondent took the view that the guidelines put too much emphasis on unfavourable conditions and could therefore result in a KII that is not sufficiently neutral and confuses investors.

The suggestion made by some stakeholders that scenarios should be accompanied by probabilities was not taken into account. CESR had already considered this option at length in the development of its technical advice to the Commission; the reasons for the final choice in favour of performance scenarios, which include the results of the consumer testing exercise, are set out extensively in both the consultation paper on the draft advice published in July 2009 (Ref. CESR/09-552) and the advice itself (Ref. CESR/09-949). In line with CESR's advice, information on probabilities was not included in Regulation (EU) No 583/2010 on Key Investor Information (hereafter 'the KII Regulation'). Given the exhaustive nature of the contents of the KII pursuant to that Regulation, any attempt to require information on probabilities via level 3 guidelines could have raised issues of consistency with the level 2 text.

CESR notes that according to the level 2 KII Regulation (Article 3(2)), the information in the KII must be fair, clear and not misleading.

CESR considered the merits of requiring a narrative explanation of the advantages and drawbacks of the formula in both the risk and reward and performance scenarios sections. However, due to the length constraints of the KII document, CESR decided that it was more appropriate to require such an explanation in only one of the sections.



In preparing the guidelines on performance scenarios, CESR paid particular attention to the need to have a balanced presentation that allows investors to make an informed decision. In certain circumstances, such as where the UCITS includes a conditional guarantee, CESR took the view that a highly unfavourable scenario should be included due to the potentially significant impact this outcome would have on the investor.

Box 1 – Definition

7. There were no comments on the definition of structured UCITS.

As there were no comments on the proposed definition of structured UCITS, CESR confirmed its proposal in the final guidelines.

Box 2 – Choice of the scenarios

Q.1 Do you agree with the proposals in Box 2?

Q.2 Are there any other scenarios which these guidelines should address?

8. Several respondents expressed their general agreement with the provisions of Box 2.
9. Some respondents sought clarification on the terms ‘unfavourable’, ‘favourable’ and ‘medium’ market conditions. One also requested further guidance on how each single market condition should be calculated and categorised within the scenarios, while another respondent called for more prescription on the meaning of these terms e.g. defining parameters of -5%, 0%, 5% (and -20% for the extreme unfavourable scenario) for the scenarios. The same respondent felt that there should be clear requirements on when a fourth scenario is mandatory, otherwise there will be inconsistency across UCITS. Two trade associations favoured more consistency with the level 2 KII Regulation, which refers to ‘circumstances in which the formula may generate a low, medium or high return’. The same respondents noted that the KII Regulation refers to the need for firms to base the scenarios on ‘reasonable and conservative’ assumptions.
10. One stakeholder felt that it should not be necessary to include an extremely negative scenario as this would have to be balanced by an extremely positive scenario (otherwise the investor may believe that the unfavourable scenario is more probable). This would result in too many scenarios. A narrative explanation of the possibility of there being both extreme negative and positive scenarios should be sufficient. In contrast, one respondent felt that consideration should be given to inclusion of an extremely unfavourable scenario, such as where a capital-protected fund includes a knock-out feature. In this context, one trade association called for clarification on the types of objective criteria that should be used to determine the ‘extreme market conditions’ under which a fourth scenario would be required.
11. One respondent suggested that an extreme scenario should be included for all structured UCITS as it would help investors:
 - understand the behaviour of such funds during extreme market conditions, at a time when investors generally have the greatest need for their cash;
 - consider liquidity when evaluating investment risk and take into account the long-term investment horizon when planning their finances; and

- integrate potential price changes of structured UCITS in their portfolio allocation and evaluate the potential payoffs of such investments if sold at dates other than those predetermined in the offering documents.
12. The same respondent felt that both the most favourable and unfavourable scenarios should be highlighted using a bolder font.
13. Several retail investor and academic representatives proposed the following alternative scenarios (accompanied by a probability in each case) as being more appropriate:
- a negative return (final value of invested capital lower than notional capital);
 - return is positive or zero but less than that of a risk-free asset;
 - return is positive and in line with that of risk-free asset; and
 - return is positive and higher than risk-free asset.
14. The same academic representative considered that probability tables based on a Monte Carlo simulation, in which the potential returns are compared with those of a risk-free asset, would be more appropriate. The representative provided reworked versions of Examples A to C using probability tables.
15. One contributor felt that the soundness and reasonableness of the scenarios should be further justified. This could be achieved in various ways:
- Basing the scenarios on historical data by leveraging off the work done for the SRRI.
 - Involving a range of functions (risk manager, investment manager etc.) in the definition of the scenarios.
 - Scenarios and underlying assumptions could be independently challenged by a third-party (auditors or regulatory body).
16. The same respondent further proposed that structured funds be given a rating for each of the following elements in order to rate their complexity, allowing an overall complexity 'score' of 0 to 6 to be awarded:
- Dimensionality: what are the qualitative risk factors of the product and how many are they?
 - Are intermediate cash-flows expected? The contract price will jump at the payment date and will impact on the value of the contract (which is important to communicate to the investor).
 - Is the contract time-dependent? Are there certain key dates specified in the contract which will have a significant impact on the value of the contract e.g. by contingently impacting the payoff structure itself?
 - Decision: the investor may be involved in making a decision during the lifetime of the contract, which is likely to significantly impact gross return.
 - Order of the contract: the contract dependence vs. the underlying risk factors might be more or less direct (e.g. when embedded options are involved) and should disclose all contingencies related to the realization of the underlying.
 - Path-dependency: some contracts propose a performance which depends on the sequence followed by a given underlying, and not only its final state.



17. This stakeholder also considered that the situations in which it is necessary to update scenarios should be clearly specified as follows:
 - where market conditions have changed significantly since the launch of the UCITS;
 - at least on a yearly basis; and
 - to reflect the time-dependency of a payoff, where relevant (e.g. where an anniversary date has passed).
18. The frequency of the updates of the scenarios should take into account the complexity score referred to above, while the triggering conditions and update policy for scenarios should be defined in a specific policy by the management company.

CESR saw merit in the requests for clarity on when the scenarios should be updated and modified the guidelines accordingly. Therefore, scenarios shall be updated (i) where market conditions have changed significantly since the launch of the UCITS; (ii) at least on a yearly basis; (iii) to reflect the time-dependency of a payoff (e.g. where an anniversary date has passed).

CESR also considered it necessary to be more precise about the choice of the scenarios. A paragraph was added to the explanatory text under the Box 2 explaining how the unfavourable scenario should be presented. If there is no guarantee of capital, the scenario will show that investors may suffer loss, where relevant, and how much this loss can be. If there is a legally enforceable guarantee of the capital, this will show conditions where the guarantee will override the formula (return equal to zero). If there is a conditional protection/guarantee barrier (conditional floor), it will be appropriate to show an additional example to illustrate how extreme conditions can breach the barrier and cause a loss of capital. This is to ensure that investors realise they could suffer substantial losses. These two examples would be categorised as 'unfavourable' and 'very unfavourable' respectively.

Concerning the high example, it should illustrate a positive return but it should not be based on unreasonably optimistic assumptions that will exaggerate the likely potential of the UCITS.

As regards the suggestions to include a comparison between the return of each scenario and that of a risk-free asset, CESR had already considered this option in the development of its level 2 advice to the Commission. CESR felt that it would be difficult to identify any asset that could be considered 'risk-free' and that making such comparisons could potentially confuse or mislead investors.

Box 3 – Presentation of the scenarios

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

19. Many respondents expressed their general agreement with the provisions in Box 3.
20. Several respondents made comments in relation to probabilities. One took the view that the presentation should include indications of probability, and that Member States such as Italy that currently take such an approach should be allowed to continue to do so. The same respondent felt that the absence of probabilities rendered the use of words such as 'very unfavourable scenario' potentially misleading, particularly when there is no equivalent for the favourable scenario. One stakeholder, meanwhile, felt that investors were likely to assume that the scenarios were equally probable if no probabilities were included. In the same context, one trade association sought further guidance on how the KII should explain that the scenarios are not equally probable,

while another felt that the term ‘not equally probable’ conveyed a potentially misleading and subjective message as investors may consider the best scenario to be the most likely.

21. Many industry representatives agreed with the discretion given to the management company to choose between tables or graphs. One industry representative, on the other hand, felt there should be additional criteria on how to choose between the use of a graph or a table. One investor representative, meanwhile, felt that the freedom of choice between graphs and tables would make it more difficult for investors to compare funds. One management company considered graphs to be preferable on the basis that they are easier to understand at first glance. The same respondent saw value in integrating all four scenarios into a single graph in order to have a more concise document and avoid confusing investors with multiple graphs. Finally, this respondent suggested using a defined colour scheme to differentiate the scenarios (black for the extremely negative scenario, red for the unfavourable, orange for the medium and green for the most favourable). In this context, one stakeholder felt that it should be possible to have both tables and graphs where this would be clearer for investors.
22. One contributor considered that it should be possible for all 3 scenarios to be presented on the same line e.g. in landscape format on the 3rd page, rather than requiring the unfavourable scenario to be explained first. This would, in their view, allow for greater comparability and balance. Similarly, another stakeholder disagreed with the requirement to explain the unfavourable scenario first, arguing that it would be more natural to start with the scenario based on highest price of the index or asset in question (which in some cases could lead to the lowest payoff, where the fund reverses the performance).
23. In one respondent’s view, tables should be preferred to graphs as a general rule as they are more easily understood by retail investors. Graphs should only be used for complex funds when tables are not appropriate or do not capture all the features of the product.
24. Regarding Box 3, point 5, it was stated that it would be preferable to use the wording included in examples B and C (regarding the fact that in case of early redemption the price will be based on the NAV of the UCITS) rather than referring to a possible loss. In the same context, one stakeholder felt that the examples should show how the warning envisaged in point 5 of Box 3 (about the impact of redemption before maturity) is to be presented.
25. In relation to point 4 of Box 3, one stakeholder felt that the requirements would be neither effective nor enforceable as the relevant information cannot be verified by competent authorities.
26. It was also suggested that the terms ‘illustrative potential outcomes’ or ‘illustrative scenarios’ would be better than ‘illustrative examples’ in conveying a sense of randomness of the potential returns. Similarly, one respondent proposed labelling the title of the section as ‘Illustrative simulations of potential payoffs’ in order to convey the point that the scenarios are based on simulations.
27. Several respondents commented on the requirement to use annualised gross returns, with one supporting this approach on the basis that it would help ensure comparability between structured products. However, the same respondent felt the following elements/disclaimers should be added:
 - The annualisation methodology should be disclosed.
 - The actual yearly performance may differ significantly from the annualised return.
 - The investor may incur a significant loss if he redeems his investment before maturity.
 - Annualised returns should not be used for investments of less than one year.



28. A trade association felt that the requirement to use annual calculations could be overly restrictive and that longer time horizons should be possible. The time horizon should always be stated. It was also proposed that the returns be presented as actual payout amounts in order to foster comparability. The association argued that annualised returns could only be calculated based on the original offer price of the product (and most investors buy the product at a different price after the original offer period). In this context, clarification was asked on whether the requirement at point 3 meant that the net rate should always be displayed.
29. One stakeholder saw merit in using the same scales for different scenarios as much as possible, except for when the range of different outcomes is very broad.
30. One respondent felt it would be helpful for the examples to take the form of good and poor practice. The same respondent took the view that some of the guidelines were not in line with the requirement to draft the KII in plain language (e.g. the warning on the impact of redemption before maturity). In the same context, one investor representative considered that the statement that the value in case of early redemption 'will depend on the market value of the underlying assets at that time' is misleading; in their view, evidence suggests this is often not the case and it is difficult to verify. As a minimum, this respondent felt that the provider should be required to disclose the detailed portfolio composition of the structured assets.

As explained above, the suggestion made by some respondents to include information on probabilities was not adopted by CESR. In this context, CESR notes that according to Article 36(6) of the level 2 KII Regulation, the KII should make clear that the scenarios shown may not have an equal probability of occurrence.

Taking into account the general support from respondents, CESR retained its proposal to allow management companies discretion in choosing between graphs and tables. In this context, CESR did not take on board the suggestion made by one stakeholder to consolidate the scenarios in a single table or graph on the basis that the resulting disclosure would not be easily readable or understandable for investors. On the point raised by the same respondent about the use of a defined colour scheme to differentiate the scenarios, CESR sees merit in the development of such techniques by management companies where they aid consumer understanding but did not consider it appropriate to prescribe such an approach in the guidelines. In this context, it is also important to note the requirement in Article 5(2) of the level 2 KII Regulation that where colours are used, they must not reduce the comprehensibility of the information in the event that the KII document is printed or photocopied in black and white.

CESR did not consider it appropriate to require UCITS to disclose the detailed portfolio composition of the structured assets in the KII since this information would not aid investor comprehension.

Similarly, CESR took the view that inclusion of the annualisation methodology in the KII would not add value in terms of information that investors can use when making an investment decision.

CESR decided to retain the term 'illustrative examples' for the scenarios on the basis that the word 'illustrative' clearly indicates that the scenarios are not to be interpreted as forecasts.

Finally, CESR decided to amend Example B to clarify that in the case of early redemption, the price will be based on the market value of the financial derivative instruments used and not the value of the underlying shares.



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

31. One stakeholder felt that in order to improve investor understanding, scenarios should be consolidated on a single table or graph with the addition of an ‘executive summary’ to summarise the results. Two respondents also saw merit in having a single table, the latter particularly for products with more complex (non-linear) structures.
32. A number of respondents considered that the requirement to have a narrative explanation of each scenario may conflict with the 3-page limit. This could be addressed by replacing the narrative explanation by a cross-reference to the full prospectus. One also noted that there was no basis for such a requirement in Article 36 of the level 2 KII Regulation and that a narrative explanation was in any case required in the objectives and investment policy section.
33. Two respondents noted that at the end date, the price is based on the NAV which includes the market value of the derivatives used but may also include exit charges, which may have a significant impact on the price and on the guarantee.

As explained above, CESR did not adopt the suggestion that scenarios should be consolidated on a single table or graph due to the potential difficulties such a presentation would pose to investors.

The level 2 KII Regulation sets a clear page limit of three sides of A4 for the KII for structured UCITS. While recognising that the requirement to have a narrative explanation of each scenario will be challenging, CESR considers that this is nevertheless possible in the space available. CESR did not adopt the suggestion of replacing the narrative description of each scenario by the use of a cross-reference to the full prospectus as this was considered to be essential information that should be contained in the KII itself.

CESR takes note of the possible impact that exit charges could play in the case of early redemption. As it would be difficult to explain such potential outcomes in a clear and concise way in the KII, CESR decided to retain its proposal that there be a warning about the possible loss on the investment in the case of early redemption.

Examples

34. Regarding the examples in general, one stakeholder asked that it be clarified whether it is the outcome or the market condition which is favourable, unfavourable or medium from the investor perspective.

CESR amended the guidelines so as to make clear that it is the outcome for the investor that should be favourable, unfavourable or medium, and clarified the link between this and the requirement in the level 2 KII Regulation regarding low, medium and high returns.

Example B

35. One stakeholder proposed replacing ‘UCITS performance’ by ‘retained performance’. The same respondent saw merit in including in the scenarios a market interest rate corresponding to a similar time horizon as the UCITS, particularly for capital-protected UCITS based on fixed-income instruments. The same respondent also felt that if CPPI-based strategies fall within the scope of structured UCITS, additional guidelines should be developed on the scenarios to be used for such dynamic investment strategies.



The inclusion of a market interest rate within the scenarios could render the scenarios too complex or illegible for investors; as such, CESR decided not to adopt this suggestion.

In light of experience following implementation of the revised UCITS Directive and the associated CESR guidelines, CESR will consider the need to develop specific guidelines on the scenarios to be used for dynamic investment strategies such as CPPI.

Example C

36. One stakeholder considered that a medium scenario should replace the very unfavourable scenario in order to have a more balanced presentation.

As explained above, in certain circumstances (such as when a fund has a guarantee with a conditional floor) CESR considers it appropriate to require the inclusion of a very unfavourable scenario due to the potentially significant impact such an outcome could have on the investor.

Annex 1: List of Respondents

	Name of respondent
1.	Austrian Federal Economic Chamber, Division Bank and Insurance
2.	Istituto di Ricerche Economiche e Sociali
3.	Confederazione Generale Italiana del Lavoro
4.	Ebsylon Sàrl
5.	Caixa Geral de Depósitos
6.	European Banking Federation
7.	Italian Banking Association
8.	Professor Cesari, University of Bologna
9.	Association française de la gestion financière
10.	Spanish Association of Collective Investment Schemes and Pension Funds
11.	Association of British Insurers
12.	Association of the Luxembourg Fund Industry
13.	European Fund and Asset Management Association
14.	Assogestioni
15.	Investment and Life Assurance Group
16.	BVI Bundesverband Investment und Asset Management
17.	Test-Achats
18.	European Federation of Investors
19.	Danish Shareholders Association
20.	EUSIPA