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Joint Associations Committee (JAC)

Response to the CESR Consultation Paper on technical issues relating to Key Information Document (KID) disclosures for UCITS

Executive summary

This response to the CESR "Consultation paper on technical issues relating to Key Information Document ("KID") disclosures for UCITS" (the "Consultation") has been prepared by the Joint Associations Committee ("JAC").[1].

The JAC is delighted to be able to respond to this Consultation Paper which highlights a number of issues which are important to the market. The JAC recognises and agrees that it is desirable to increase transparency in UCITS and to provide information that investors can reasonably understand in order to reach investment decisions on an informed basis. However, some concern has been expressed by members that the current formulation of KID may not adequately reflect the overriding principles that key investor information should include "appropriate product information about the essential characteristics of the UCITS concerned" to enable investors to reasonably understand the nature and risks of the investment product as well as providing a level playing field to all market participants.

The members of the JAC have expressed particular interest in relation to the impact of the Consultation on structured funds ("Structured Funds"). Structured Funds are those funds where the return is the result of a formula that links the return to the value of some underlying securities or indices at certain dates. Structured Funds are often, but not always, capital guaranteed (either in the form of a "hard guarantee" where a fraction of the full amount invested is guaranteed at maturity of the fund or a "soft guarantee" where the principal protection is contingent on the performance of the underlying). The underlyings are sometimes indices but more often are baskets of shares. The returns are often linked to the prices reached, at some pre-determined dates, by shares that belong to a pre-defined basket. Structured Funds are subject to a form of passive management, similar in many ways to index funds. However, unlike index funds, they allow a customised risk profile, with a mix of risks and returns that is able to fit some investors needs better than pure index funds.

Structured funds generally offer investors an exposure that is adapted to the investor market scenario anticipation over the term of the fund. By contrast to open-ended funds (market funds/absolute return funds/life cycle funds), Structured Funds allow investors to materialise and exploit a precise long term view and scenario of the market.

The main advantage of Structured Funds as a complement to other fund investments is to provide a diversification of risk profiles. Indeed, academic research has shown that Structured Funds fulfil

[1] The JAC is sponsored by: International Swaps and Derivatives Association (**ISDA)** and Securities and Financial Industry Financial Markets Association (**SIFMA**). Fuller descriptions can be found in Appendix 1 but in the first instance any queries can be addressed to rmetcalfe@isda.org

a useful diversification role[2] and plays a significant role in Europe, with many innovations being continuously brought to the market.

Members also noted that that the recent Commission Consultation on "Packaged Retail Investment Products" ("PRIPS") published on 30 April 2009 proposes to extend the use of a KID (or similar document) to other products sold to retail investors (including structured securities, structured deposits and some insurance products). We note the extensive background to the Consultation undertaken by CESR to date but we would suggest that wider consultation on the contents of the KID is undertaken at this stage in order to obtain participation from stakeholders in all affected products as the findings of the current exercise in relation to the KID as used in UCITS may potentially have wider impact upon other PRIPS. (For example, the experts groups consulted to date have only been represented by members of the asset management industry and we would encourage CESR to consult more widely and, in particular, to involve members of the investment banking and insurance industries since the current formulation of KID may not be appropriate to other products and markets).

This response focuses on the two areas of the Consultation that are of most concern to our members: "Risk and Reward Disclosure" and "Past Performance". The JAC has received a range of views from its members which we have reflected in the more detailed responses below. We summarise below some of the salient points from our response as follows:

Risk and Reward Disclosure

The JAC has serious concerns over the use of and reliance upon volatility as a reliable measure of future risk/reward. In particular, volatility focuses on short term and market risk; in the current environment, investors are likely to be concerned with an analysis of a long term risk profile (e.g. VaR) as well as non-market risks such as risk of fraud, liquidity events, operational risk and credit risk. If, as is the preference of some of our membership, CESR recommends the use of VaR as a measurement of risk across all UCITS, a single synthetic risk indicator, to provide a high level indication of risk, it would serve a useful purpose and be a more reliable risk measure than volatility across all funds. However, some members would favour the use of narrative disclosure as opposed to a synthetic risk indicator.

There was a strong consensus amongst members that the inclusion of an exclamation mark (!) for Structured Funds threatens one of the key objectives of the KID which is to provide a level playing field for all participants. In addition, members are keen to explore with CESR how far the use of the exclamation mark would extend to other PRIPS.

Past performance

Whilst there is an acceptance in the Consultation that actively managed funds can demonstrate their past performance, CESR proposes that the use of historic simulations (which are the

[2] See for example the research of Edhec Risk Research Centre:http://www.edhec-risk.com/derivatives/structured_products

equivalent of past performance for passively managed funds) will not be permitted in relation to Structured Funds. Members acknowledge that whilst back testing may not be the only way to present information to investors, it is of vital importance in providing investors with an indication of the return on their investments and, without, back testing the quality of disclosure is significantly jeopardised.

CESR notes in the Consultation that there is a risk of "gaming" if back testing is used by Structured Funds. Members expressed strong views that no methodology is immune from the risk of gaming and members do not believe that the risk of gaming is more inherent in the provision of back-tests for Structured Funds than in relation to benchmarks used by any other funds. In the interests of the wider industry, members are keen to work with CESR to discuss and overcome any concerns regarding gaming in the context of back-testing and any other methodologies.

No pricing of risk premium

The Consultation proposes that the expected return of Structured Funds in a risk neutral world is presented to investors. Whatever solution is adopted by CESR, all types of funds (market, strategy or Structured Funds) should be treated equally, with consistent risk measures and similar disclosure on past performances.

FULL RESPONSE

1 Chapter 1: Risk and Reward Disclosure – Option B synthetic risk and reward indicator

CESR is seeking views on the technical issues that would need to be addressed in relation to the provision of Option B – synthetic risk and reward indicator. In the Consultation, CESR suggests that the risk and reward indicator for UCITS funds may be represented by calculating, whenever possible, historical volatility.

The Consultation points out that with respect to Structured Funds "*the difference with life cycle /target maturity-type funds is that, depending on market dynamics, the structured fund allocation (and hence its risk profile) can change quite quickly and drastically. For this reason no history can be deemed representative of the fund's current allocation or suitable for the estimation of its volatility*". Consequently, the Consultation proposes the use of the historical volatility of the initial replicating portfolio for fixed maturity funds ("delta representation") and the volatility of the "current mix" for infinite maturity products.

The JAC received a range of views from its members but there was a strong consensus that the use of historical volatility would not be sufficient. Many participants do not believe that volatility fairly reflects the relevant risk and reward profile of Structured Funds (or other structured products). If, as is the preference of some of our membership, CESR recommends the use of VaR as a measurement of risk across all UCITS, a single synthetic risk indicator, giving a high level indication of risk, it would serve a useful purpose and be a more reliable risk measure than volatility across all funds. However, some members would favour the use of narrative disclosure as opposed to a synthetic risk indicator. For the sake of clarity for investors, and a level playing field across all types of products, any indicator (in synthetic form or on the basis of a narrative disclosure) should be applicable across all types of funds.

Question 1: Would the proposed calculation methodology lead to a categorisation of funds' potential risk and reward profiles which is clear, appropriate, comprehensive and easy to implement?

There was a strong consensus that volatility is a valuable tool in providing information on the short term risk and reward profiles to investors. However several shortcomings were highlighted and, in particular, there was discussion as to whether volatility is a suitable measurement for Structured Funds and, indeed, any other funds. Members highlighted the following issues:

1.1 Applicability to Structured Funds

1.1.1 Investment horizon

Structured Funds are a passive form of investment allowing investors to materialise and exploit their long-term views of the market. The return of the fund will be driven by the realisation (or not) of the envisioned scenario and will be computed at maturity of the fund using a predefined formula.

Investors in Structured Funds usually assess the risk of their investment over a long time frame. Investors intend, in general, to hold to their investment until maturity (or at least until the moment when the scenario envisioned by the funds will be deemed to have realised itself or not). This is evidenced by, for example, at the request of French regulators, French Structured Funds including a warning written in bold on the first page of their prospectus which says: "the (…) fund is built on the basis of an investment for the whole life of the fund (…)"[3].

Any measure of risk involved in Structured Funds must, therefore, be a long term risk measure – in line with the time horizon of investment into those funds.

Members acknowledge that volatility is a useful measure of short term risk but is not as relevant to measuring longer term risk and, in particular, risks relating to investments likely to be held to maturity; the Consultation itself points out in paragraph 1.2.3: "*volatility models are developed, tested and implemented for short (trading) horizons, not for annual periods. Their validity cannot be generalised for longer time horizons*".

1.1.2 Return distribution for Structured Funds

It is stressed in the Consultation that for volatility to be a relevant risk indicator, the distribution of return of the fund should be close to normal and as symmetric as possible. The Consultation rightly points out that, if for some funds daily returns can be skewed, the distribution becomes close to normal when looking at larger observation intervals.

However this analysis does not hold true for Structured Funds (nor for many other types of funds/other structured products). Structured Funds are a way for investors to gain or protect themselves from the occurrence of a given market scenario at maturity of the fund. This results in a significant distortion of the distribution of return at maturity as compared to a standard normal/lognormal distribution.

The charts below show the Monte-Carlo distribution of 5-year return of:

(i) an equity fund representing a tracker in the XYZ index

(ii) a Structured Fund offering full principal protection over its life of 5 years from now (100% floor) and 130% participation in the XYZ index

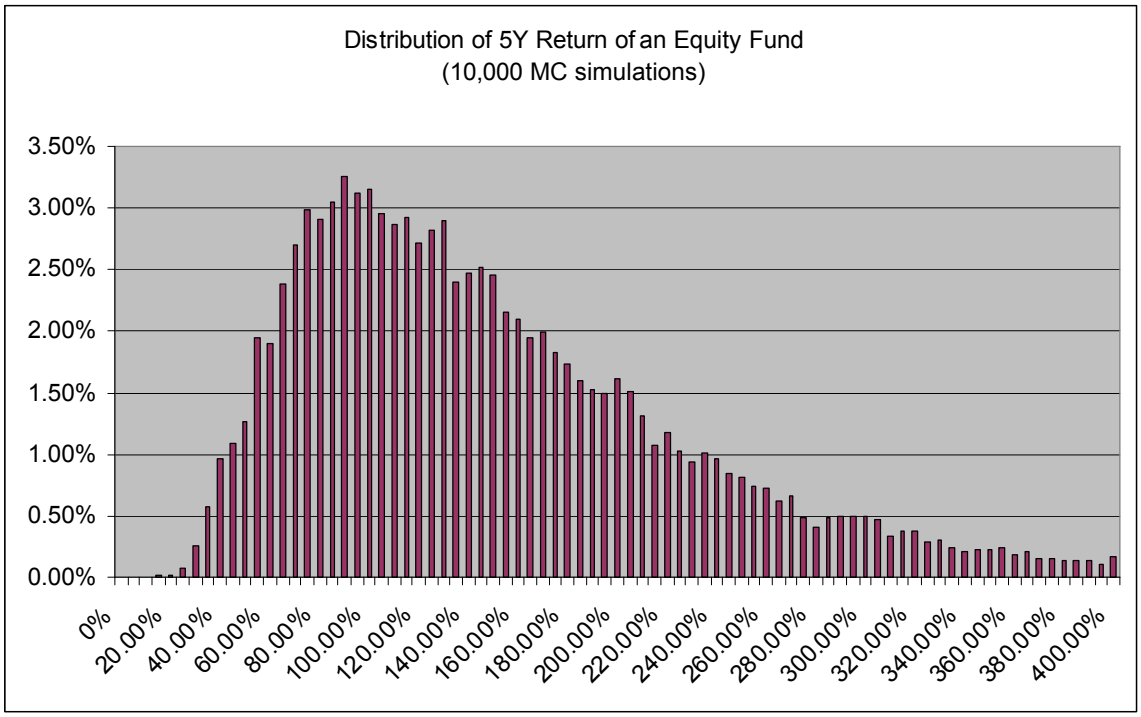
(iii) the delta representation of the previous Structured Fund i.e. a portfolio consisting of a long position of 68% in the index XYZ and 32% in a 5-year zero-bond.

The same parameters as in paragraph 1.2.6 of the consultation have been used for modeling purposes: interest rates of 4.7%, volatility of 25% for XYZ index.

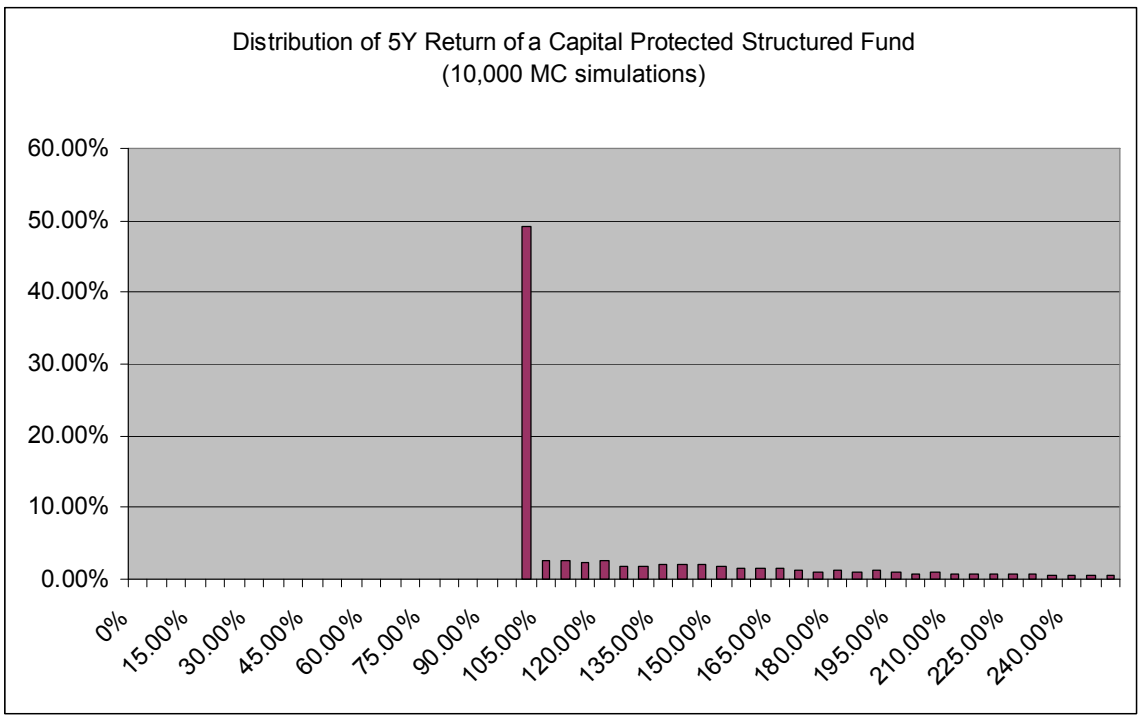
We assumed the volatility of a 5-year zero-coupon bond to be equal to 8% and a correlation between 5-year zero-coupon bond and XYZ to be equal to -30%.

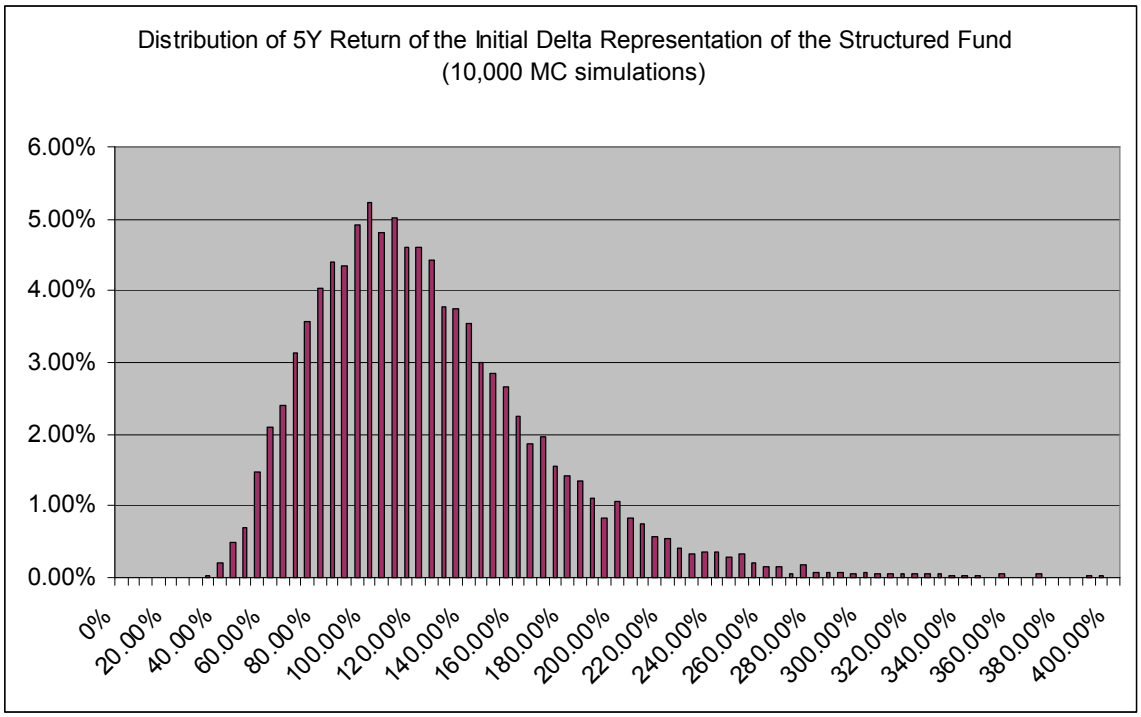
[3] « Le fonds (…) est construit dans la perspective d'un investissement pour la durée de vie du fonds (…) »

(i) equity fund tracking XYZ index



(ii) capital protected Structured Fund linked to XYZ index





In this particular example the downside risk at maturity on the Structured Fund is much lower than on the delta representation at inception of the Structured Fund: the minimum payoff at maturity on the Structured Fund is 100% of the initial investment thanks to the capital protection, when the delta representation shows a much lower return.

Therefore if the volatility of the delta representation was to be used as a risk indicator, the level of risk perceived by the investor would be much higher that it actually is.

1.2 Applicability to other funds

Volatility may be an acceptable measure of risk, to some degree, for money market funds, funds invested in bonds in a constant proportion and funds invested in standard equities with a constant proportion. For all other funds (including Structured Funds, funds employing a quantitative strategy, funds with a variable leverage or investing in emerging markets), the proposed indicator would, in the view of members, be inappropriate to evaluate fully the inherent risks.

Volatility cannot take into account any degree of exposure to alternative strategies such as are now permitted under UCITS III. As long as strategies use non linear instruments, such as derivatives, it is widely accepted that volatility is not appropriately adapted for use as a tool to measure or represent risk. For example, the EU Commission recommendation on derivatives[4] proposes only three methods to compute risks in UCITS. See recital 5: "*It is therefore necessary to*

[4] Commission Recommendation 2004/383/EC of 27 April 2004 on the use of financial derivative instruments for undertakings for collective investment in transferable securities (UCITS) - http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:32004H0383R(01):EN:HTML

recommend possible approaches of market risk measurement, by clarifying the conditions for the use of the following types of methodologies: the commitment approach; the Value-at-Risk approach (VaR-approach) and stress tests".

1.3 Short term risk indicator

The idea behind volatility is that the risk relating to a fund can be determined at a given time independently from the investment horizon. Many members strongly disagreed with this analysis and suggested that an investor's decision as to whether to invest in a product will depend on the length of their investment. Indeed, in its February 2008 advice to the European Commission[5], CESR mentions in point 5.31: "the investment horizon is one of the important features an investor and their adviser should be looking at".

What is important for an investor in a Structured Fund, as in most other types of fund, is the level of risk over the period of their investment. Investors need to know, through the risk indicator, whether they are likely or not to lose a significant part of their capital. By focusing on historical volatility as a key risk measure, an investor is encouraged to look at a short term view of risk in order to speculate, rather than a long term view of risk which is able to guide them for a long term investment in which they can invest their savings at a time when encouraging long term savings is vital to the long term health of the EU economy.

1.4 Recent market events

Realised volatility at the beginning of 2007 was at an all-time low, and therefore using volatility as a risk measure would have proved a very poor indicator in the light of the recent crisis. This can be illustrated, for example, using the Eurostoxx 50 index, which is a benchmark used by many Euro-based equity funds.

The Eurostoxx 50 has a "peak-to-valley" loss of more than 60%. Between the peak of the market, 16 July 2007, and the valley, 9 March 2009, the index went from 4557.57 to 1809.98, which is a loss of more than 60%.

At the same time, if volatility had been used at that time, these equity funds could have been seen as a low risk product. The 1-year historical volatility was 17.9% on 16 July 2007 which was fairly low by historical standards. Such volatility was 30% on 11 May 2009 and has reached 44% in October 2008.

This example illustrates why volatility is often a poor and misleading indicator of risks. Whilst being helpful in indicating the short term "vibration" of the returns, it may not be as helpful in determining the actual risk of loss.

In addition, members highlighted the importance of other non-market risks such as the risk of fraud, liquidity risk, operational risk and credit risk as other important considerations for investors.

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[5] CESR's advice to the European Commission on the content and form of Key Information Document disclosures for UCITS. Ref. CESR/08-087 http://www.cesr-eu.org/index.php?page=contenu_groups&id=28&docmore=1#doc

1.5 Value at Risk

1.5.1 What is Value at Risk?

Value at Risk (VaR) is a widely used measure of the risk of loss with a given degree of confidence on a specific portfolio of financial assets over a certain time horizon. Indeed VaR is the method that is recommended by the Commission for the management of derivative risks in UCITS[6].

For a given portfolio, probability and time horizon, VaR is defined as a threshold value such that the probability that the mark-to-market loss on the portfolio over the given time horizon exceeds this value (assuming normal markets and no trading) is the given probability level.

For example, if a Fund has a 5 year 95% VaR of 20% , there is a 5% probability that the portfolio will fall in value by more than 20% over a 5 year period, assuming markets are normal, and the Fund keeps the same investment policy.

1.5.2 How to compute VaR?

For market funds and strategy funds, some members recommend calculating VaR by using historical data, and a standard maturity that is in line with any recommended holding period, typically 5 to 6 years, in order for this indicator to be robust. This would reflect better the overriding principle outlined in the paper that the KID should be "clear, appropriate, comprehensive and easy to implement".

The risk indicator would be the "expected possible loss" over a 5-year period and the KID would include a sentence such as: "according to statistical models, the fund has an expected possible loss of x% over a period of 5 years".

For Structured Funds with a fixed maturity, some members recommend calculating the historical VaR at maturity of the fund using the back-tested data of the fund, by taking the 5% worst performances. In order to compute an indicator that is not maturity-dependant, some members would adjust the equivalent risk profile for a 5-year maturity, according to a log-normal distribution.

When market funds or strategy funds do not have 5 years of historical data, but have, for example, 3 year data, some members propose to compute VaR to the existing 3 year track record, and correcting it to a 5-year VaR according to log-normal distributions. However, the disclosure should be followed by additional text referring to this lack of data and the fact that actual risk may be higher.

These calculations are simple and could be put in place by any UCITS manager. They would also be straightforward for regulators to monitor and control.

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[6] Commission Recommendation 2004/383/EC of 27 April 2004 on the use of financial derivative instruments for undertakings for collective investment in transferable securities (UCITS) - http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:32004H0383R(01):EN:HTML

1.6 Question 7: Does the methodology cover all UCITS types? More specifically, do you agree with the proposed approach of distinguishing between market funds, strategy funds, and structured funds (including guaranteed funds) and the adaptation of the calculation methodology to each of these fund types?

Many members have expressed the view that the proposed volatility methodology is an inappropriate measure for any type of fund which does not have a log-normal distribution: for example, Structured Funds, many quantitative funds and absolute return funds. Risk involved in Structured Funds cannot be measured by volatility, which is a short term indicator. It fails to grasp the long term risks involved in Structured Funds.

Also adopting a delta representation has 2 major drawbacks:

- it fails to grasp the diversification of risk profile involved in Structured Funds (even 2 Structured Funds can have the same delta representation at inception with significantly different risk profiles at maturity);

- the delta representation is model dependant: it depends on the parameters (volatility, implied dividend yield) used by the issuer to compute the delta of the Structured Fund. Therefore the delta representation cannot be deemed to be an "objective" way of representing a Structured Fund.

Some members believe that Value at Risk (VAR), based, as regards Structured Funds, on historical simulations is a more relevant indicator than volatility and should be used across all types of funds to provide a level playing field for all participants.

1.7 Question 8: As regards the use of a 'risk add-on' and an exclamation mark(!) in situations as presented in the above section, what are the merits and limits of each solution? Can you suggest another option to tackle the described situation?

Some members believe that VaR is a measure that may be applied to every type of fund; hence members do not recommend the use of an exclamation mark (that might be perceived negatively by end investors) nor the use of a risk add-on, except in very exceptional circumstances for funds that do not have enough track record or historical simulations.

The recent twists and turns of the equity market plead rather in favour of a VaR measure of risk rather than a volatility approach. Realised volatility at the beginning of 2007 was at an all-time low, and therefore using volatility as a risk measure would have proved a very poor indicator in the light of the recent crisis (see 1.4 above).

1.8 Question 9: Are the proposed solutions (systematic classification into category 7, use of a 'risk add-on' or a modifier) to tackle situations of a potentially changing risk profile appropriate and commensurate? What are the merits and limits of each option?

For Structured Funds, the historical VaR measure enables investors to be made aware of the changing risk profile over the entire duration of their holding (which will usually be the maturity of the funds).

Members would, therefore, argue that the systematic classification of such funds into category 7 or the inclusion of risk add-on are potentially misleading ways of dealing with changing risk profile investments. A systematic classification of Structured Funds into category 7 would seem to be against the overriding concept of a level playing field, by making Structured Funds appear risky, whereas in fact many of them may well be less risky on the basis that they are capital-guaranteed. The current proposal could lead to, for example, an equity fund indexed on the Eurostoxx 50, classified in category 2 or 3, for example, and the same fund indexed on the Eurostoxx 50, but supplemented by a capital guarantee, to be classified in category 7. This would give investors an inaccurate assessment of the risks inherent in such a product.

1.9 Question 10: In particular, do you agree that category 7 should be the highest risk and reward category as well as the special category for certain funds e.g. those with severe event risk?

The highest category should not be used as a default for all other categories of fund that cannot otherwise easily be accommodated. To do so would be misleading and would merely acknowledge the inadequacies of the methodology adopted.

1.10 Question 11: Do you foresee any other situations where the methodology may not be expected to capture appropriately the risk profile of the fund? If so, what solution should be considered?

CESR points to guaranteed funds in paragraph 79 and members would comment:

Example of structured fund which would have zero volatility

From CESR 79:

"guaranteed funds could be classified according to the historical volatility of the 'replicating portfolio mix' prevailing at the valuation date."

A structured fund containing

1) 50% exposure to a European put with strike equal to the forward of the underlying

+

2) 50% exposure to a European call with strike equal to the forward of the underlying

would have a replicating portfolio mix with no net exposure to the underlying (it has 0 delta). By using the current methodology this fund would have zero volatility and a 0 risk profile. This is unrepresentative of the risk of the product.

In addition, some members also commented on the range of risks that, given recent events are more likely to be of concern to investors including risk of fraud (e.g. Madoff), liquidity events, operational risks and credit risk. Overall some members believed that it would be difficult to determine any synthetic risk indicator which would adequately reflect all risks and would not lead to potential litigation and unintended consequences.

1.11 Question 14: Do you agree with the proposed scale and that the number of categories should be 7?

In principle, a scale of risk categories to be used as indicators of levels of risk can be useful but, of themselves, such a scale cannot convey the complexity in a given product. Risk is not a linear concept and the risk profile of a given product can change over time due to, for example, the volatility of underlying assets, indices or markets.

1.12 Question 15: How should the methodology define appropriate volatility 'buckets'? Do you agree that a non-linear scale might be needed to tackle issues of stability, granularity and fair distribution of funds along the scale? Would it be sufficient to prescribe numeric parameters to each 'bucket', or would additional definitions be necessary?

As risk is not a static concept, members believe that it would be more effective to state a range of risks for a given fund and, in any event, it should be made clear that the risk categories and/or risk profile of the product is not fixed to a given number. A more effective representation might be a categorisation chart based on several characteristics including investors' investment horizon, market outlook, desire for principal protection and investment objectives. A specified set of symbols could be used to assist investors with emphasis placed on a scale rather than a hardwired number. Should volatility (and to a lesser extent VAR) be chosen as a risk measure, a careful choice of risk buckets is necessary to reduce the frequency with which funds change risk categories. Nevertheless, funds can be expected to move between volatility based risk groups and this could be confusing for investors. A solution to this problem would be to use volatility (or VAR) as a risk measure in a relative sense (as compared to a 'typical' reference assets). This would provide a much more stable and informative risk measure than fixed buckets. For example, key disclosure to an end investor would be "is my fund more or less volatile than a typical equity investment" rather than the isolated and less relevant question of "what is the fund's volatility this year."

One example provided relating to the CESR range of categories is as follows:

Example of Range of Categories for risk measure:

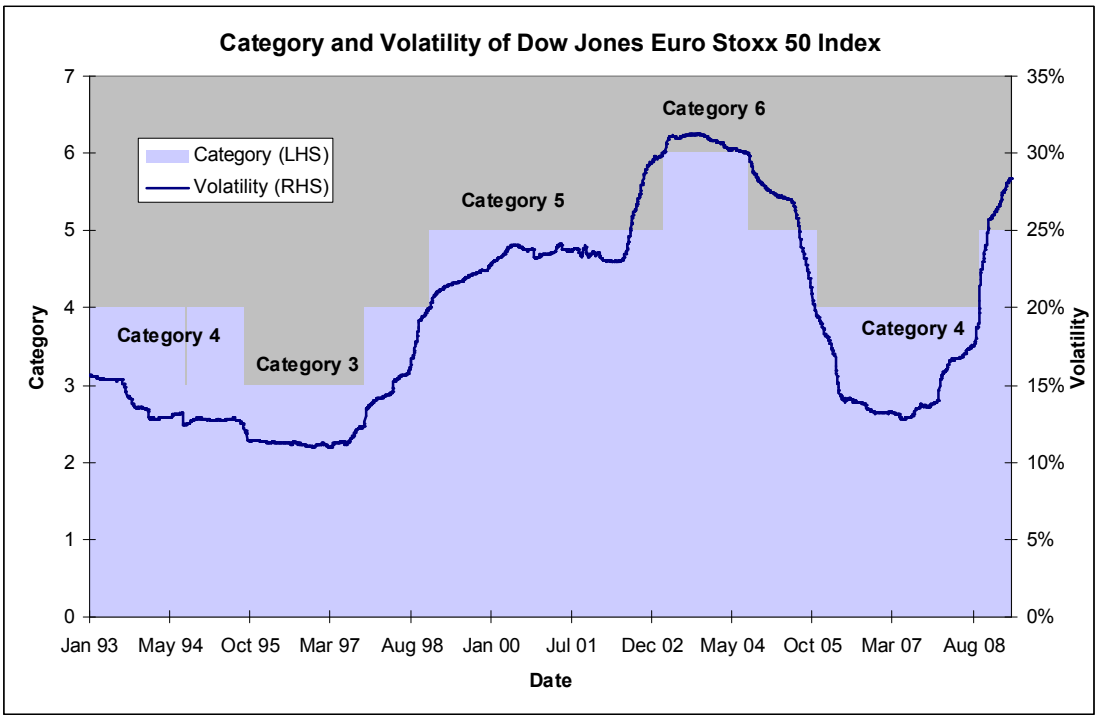
Categories assumed:

Lower Volatility Range	Higher Volatility Range	Category
0%	5.0%	1
5%	7.5%	2
7.5%	12.5%	3
12.5%	20%	4
20%	30%	5
30%	50%	6

50%	100%	7

See CESR 87 for comments on scale.

Category through time for Dow Jones Euro Stoxx 50 Index (SX5E)



For a product as mainstream as SX5E, the category varies between 3 and 6 as shown above. Careful choice of the volatility buckets can reduce this but, as mentioned above, fundamentally grouping by volatility can only be informative in a relative sense."

2 Chapter 2: Past Performance

We note that in para 2.2 of the Consultation, CESR states that past performance is not adapted to all types of funds especially Structured Funds and the consultation paper details three options concerning the presentation of potential performances of Structured Funds:

- Option A (chapter 2.2.1. points 49 to 52, page 39) consists of the publication of back testing results;
- Option B (chapter 2.2.2. points 53 to 62, page 39) consists of the publication of prospective scenarios;
- Option C (chapter 2.2.3. points 63 to 79, page 40) consists of the publication of prospective scenarios based on probability tables.

We set out below our comments on each Option.

2.1 Option A: publication of back test results

Question 45: Do you agree with the approach proposed by CESR as regards back testing?

We strongly urge CESR to reconsider its approach to back testing for Structured Funds for the reasons outlined below.

Question 46: Are you aware of any other merits that might support further consideration of this option?

Please see responses below

2.1.1 The purpose of historic simulations

It is very common for historic simulation, also known as "back-testing", to be provided to investors in Structured Funds.

The return of a Structured Fund at maturity is related to the price of a specified underlying. The calculated returns of such product (for example, if it had been issued 5 years ago, 6 years ago, 7 years ago) provide investors with some insight on performance potential of Structured Funds. These performances are especially useful when they are compared to the performance of the underlying. For example, the performance of a Structured Fund based on a basket of shares will be compared with the performance of the basket of shares itself.

Such data give investors a better understanding of the structure and the mechanism involved. They also give investors an idea of the returns they can expect, to the extent that the market conditions of the past are an indication of the market conditions of the future. Whilst we recognise that the use of back-testing, alone, has limitations, it is a valuable mechanism for providing clear, appropriate and comprehensive information to investors and, accordingly, we would strongly recommend that CESR reviews its approach to back testing for Structured Funds. We note that the use of market or strategy fund track record will have limitations and by failing to recognise such limitations CESR is contributing to the lack of a level playing field in this area. Market conditions of the future are unlikely to replicate those of the past: markets may move differently and stochastic parameters (volatility of markets for example) may also be different.

In spite of such limitations, back-testing is extremely valuable, because it allows simulation of a product on actual market returns. Even if these market returns belong to the past, this is a more objective approach than to simulate them on purely arbitrary scenarios. If the period of back-testing is sufficiently important, it allows the investor to see the behaviour of the product in different market environments, such as boom and bust cycles (for example 1998-2000 or the 2004-2008 phase).

Any type of strategy that is supposed to bring profits in the future must first be tested on the past. Another advantage of back-testing is that it helps investors to understand the actual behaviour of

the product in real (albeit historic) market conditions. We believe that such advantages should be taken into account.

Indeed, professional investors are used to being provided with back-testings and failure to provide such information to retail investors would represent a failure to make full disclosure to retail investors.

2.2 Back-testing is already allowed by the MIF level 2 Directive

Article 27 (5) of MIF level 2 Directive[7] allows "historic simulations", i.e. back-tests, provided they follow certain rules that aim to protect investors. For the sake of harmonisation and a level playing field, it would not make logical sense nor good policy to allow them in a marketing document relating to an investment product, and then prohibit them in the KID.

2.3 Back-testing can be made easy to read

One of the two arguments against back-testing issued in the Consultation is that: "*out of the 3 formats tested, back-testing was misunderstood more than the other variants. There is a risk that investors might misunderstand the examples given and interpret past figures as future performance*."

Members pointed out that any type of data presented to investors may be misinterpreted (e.g. past performance or probability scenarios).

We believe that back-testing can be presented in a straightforward and comprehensible way and propose to adopt the same format as the one that is presented for probabilities at point 66, page 41. Indeed back-tests provide a set of probabilities that are superior to the "risk neutral" probabilities presented as Option C, because they are based on actual market situations that have happened in the past, not on arbitrary stochastic simulations, like in Option C.

An example of the format that we propose is the following:

Simulated Return of the Fund over the last 10 years

EVENTS	**PROBABILITY** Based on the last 10 years markets
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%

[7] COMMISSION DIRECTIVE 2006/73/EC of 10 August 2006 implementing Directive 2004/39/EC of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive

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%

In order to compute this table, the performances of the Structured Fund would be calculated as if the Fund had been launched every day or week during 10 years, the first day being such that the Fund would have matured 10 years earlier than now, and the last day being such that the Fund would have matured yesterday. This gives a distribution of performances based on real market situations during 10 years that can be presented in the form of a probability table. Such table is easy to understand and the information is extremely valuable to investors.

2.4 How to avoid gaming?

The second argument of the consultation against back-testing is the "gaming" argument: "*Furthermore, CESR had noted the risk that a presentation using back-testing might easily be 'gamed' by tailoring the fund formula in order to present flattering data*".

Members acknowledged that no methodology is immune from the risk of gaming and they do not believe that the risk of gaming is more inherent in the provision of back-tests for Structured Funds than in relation to benchmarks used by any other funds (for example, track records can also be manipulated and presented in a more favourable light). Members would be keen to work with CESR to address any particular concerns CESR has in relation to examples of or techniques relating to gaming that CESR has come across in the Structured Funds arena and members would not be averse to working with CESR to articulate the parameters for the proper and reasonable application of back testing to Structured Funds to ensure that any back testing methodology is sufficiently robust to prevent the use of gaming. One example which has been suggested is to make use of a "rolling back-test" (for, say, a 5 to 10 year period) with mandated reference points to ensure robust criteria for comparison.

3 Option B: publication of prospective scenarios

3.1 Advantages of prospective scenarios

There was a strong consensus from members agreeing with CESR consultation wording (point 56 page 39): "*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. Findings from the first phase of consumer testing show that prospective scenarios lead to a good level of understanding by investors*."

In France, scenarios have been mandatory in simplified prospectuses of Structured Funds since 2002 and they have proven to be very useful.

3.2 Favourable scenarios

In point 59, page 40 of the Consultation, CESR states that: "*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*."

It is suggested by French members that in their experience, French prospectuses were not misleading to investors. We should also keep in mind that UCITS are authorised by regulators and that the KID would be subject to some approval from regulators. It seems unlikely that regulators would approve a KID that only covered favourable scenarios.

3.3 Simplicity of scenarios

Scenarios are one method of providing simple and non controversial information, in order to enhance the understanding of the fund by investors which are less susceptible to "gaming" have the advantage over some other methodology in that they do not purport to provide standardised data that would be relevant for any fund or category of fund and that summarise the characteristics of a fund with a hardwired number.

3.4 Question 47: Do you agree that Option B is capable of meeting the Directive requirement for performance scenarios?

We prefer Option A, which is to publish back-testing. However, we believe that Option B could also be included as a complement to Option A.

3.5 Question 48: Regarding the graph or table presentation, what are the technical merits and limitations of each option?

Many members did not have strong views as to whether information should be presented in a graph or tabular form. However, if a graph is used, CESR may wish to consider extending the length of the KID to more than 2 pages in order to include such data.

3.6 Question 49: To what extent does each option provide the investor with the elements needed for an appropriate understanding of how the fund works? Is one option clearer and more comprehensible from the investor's perspective? Is there any technical feature which may be subject to misinterpretation by the investor?

Most members did not have strong views. One participant commented that the graph option may provide a more detailed and therefore more interesting and comprehensible solution for investors.

3.7 Question 50: Is there a need for a more prescriptive approach to the number and type of scenarios that should be selected in order to ensure appropriate comparability of funds? Should any technical feature be supplemented?

No prescriptive approach would allow the inclusion of any type of fund. We should rely on the responsibility of asset managers and on the control by regulators to make sure that the scenarios are appropriately chosen.

3.8 Question 51: Is comparability with the possible risk-free asset return helpful?

Yes it is helpful. The alternative would be to use rough, return numbers which could be misleading by making investors forget that, without taking any risk, they can also obtain some return.

3.9 Question 52: Is this approach easy for UCITS providers to implement?

This approach has been tested in France since 2002 and members with experience in the French market commented that the provisions have been demanding but manageable. Members would be happy to work with CESR to develop a common approach.

3.10 Question 53: Should any other issues be taken into account regarding prospective scenarios?

No we do not see other issues.

4 Option C: publication of prospective scenarios based on probability tables

4.1 Real probabilities and risk neutral probabilities

The consensus from market participants is that prospective scenarios based on probability tables are not helpful in providing clear information to investors, threaten the level playing field and in some situations would be challenging to audit and monitor.

Risk neutral stochastic models are models that are used in order to price options. As option theory shows, they are appropriate models to price options but are inappropriate to give a view of expected returns on an asset.

This classic paradox in option pricing theory is outlined, for example in John Hull[8], chapters 10.1 and 10.2 on one-step binomial models and risk-neutral valuation:

"*The option-pricing formula in equation (…) does not involve the probabilities of the stock price moving up or down. (…) This is surprising and counterintuitive (…).*

[8] John C. Hull: Options, Futures and other Derivatives, Prentice Hall, fifth edition

In a risk-neutral world all individuals are indifferent to risk. In such a world investors require no compensation for risk, and the expected return on all securities is the risk-free interest rate." (…)

This result is an example of an important general principle in option pricing known as "risk-neutral valuation". This principle states that we can assume the world is risk neutral when pricing an option. The price we obtain is correct not just in a risk-neutral world but in the real world as well.

The argument is that the risk-neutral model is a model that is efficient to price options because this corresponds with the reality of options hedging. However, the idea of the KID is to give the investor an idea of the "real world" risk-return profile. Therefore, a risk-neutral analysis is not an appropriate measure.

The risk-neutral world is a theoretical world that is useful only to provide an accurate and tractable pricing framework. Representing the real world as risk neutral even for specific purposes is misleading and contrary to simple good sense and basic market observations. The real world has risks, and the expected return on any asset bears some relation to its risks.

4.2 Possibility of misleading results

Example

An equity fund invests 100% of its assets in an equity index, for example. In a risk neutral world, the average return of such fund would be the risk free rate of return minus the fees and expenses.

Indeed, any fund invested in any type of assets would produce the same average return: the risk free rate minus the costs. The expected return of any fund would be equal to the expected return of cash, minus the costs.

By definition, no real risk is taken into account. But what is the purpose of, for example, investing in equities if the average return is the same as the return on risk free assets? The obvious conclusion of a risk neutral approach is that investors should invest only in risk-free assets, which have a better expected return, with less costs, and no risk.

4.3 Applicability to other funds

From a level playing field standpoint, it would not make sense to provide risk-neutral probabilities on Structured Funds and not for other funds. If the return of risks is discarded for Structured Funds, it should be discarded for other funds too. For the sake of having a level playing field, the probability table that is presented on point 66, page 41 of the consultation document, should be also included in the KID of any fund, even when this is not a Structured Fund.

4.4 Real probabilities vs risk-neutral probabilities

Members commented that there are two ways to evaluate real probabilities:

- Risk Premium

Theoretically, probabilities can be inferred from risk premium. For example, we can infer from equity risk premium the real probabilities that are priced by the market for equities. The problem is that there is no consensus on how to calculate them.

- Historical Probabilities

Using historical probabilities is the only objective way of calculating real probabilities. We, therefore, refer back to Option A, since back-testing is the appropriate way to compute probabilities based on historical performances.

4.5 Question 54: Are the methodological requirements which underpin probability tables sufficient, clear and appropriate?

As shown before (see our paragraphs 4.1 to 4.4), they are not appropriate. They rely on a risk-neutral world that does not exist and, therefore risks are mispriced.

4.6 Question 55: Would such an approach cover all types of fund for which neither past performance nor a proxy can be used?

If risk-neutral probabilities are to be retained, they should be extended to cover all funds, not only Structured Funds, for the sake of clarify of disclosure and a level playing field.

4.7 Question 56: Is this approach easy for UCITS providers to implement?

No, that would not be easy, because regulators would have to decide on:

- models used;

- more importantly, which parameters are used. This may be arbitrary in practice since those parameters may not have public prices.

4.8 Question 57: Should any other issues be taken into account as regards the use of probability tables?

The level playing field between different sorts of funds. If such methodology were to be used for Structured Funds, there is no reason to use it also for other types of funds.

5 Chapter 3: Charges

5.1 Question 62: do you agree with the proposal to:

(i) show the ongoing fund charges figure excluding performance fees?

(ii) explain performance fees through a narrative description?

We received a comment from members that the market practice among some participants in certain jurisdictions already includes substantial disclosure on ongoing fund charges including

performance fees and transaction costs. Disclosure of fees excluding performance fees may, therefore, be a regression from best practice amongst some firms.

Appendix 1 - The Respondent Associations

ISDA®

ISDA, which represents participants in the privately negotiated derivatives industry, is the largest global financial trade association, by number of member firms. ISDA (the International Swaps and Derivatives Association) was chartered in 1985, and today has over 725 member institutions from 50 countries on six continents. These members include most of the world's major institutions that deal in privately negotiated derivatives, as well as many of the businesses, governmental entities and other end users that rely on over-the-counter derivatives to manage efficiently the financial market risks inherent in their core economic activities. Information about ISDA and its activities is available on the Association's web site: www.isda.org

SIFMA
Securities Industry and Financial Markets Association

The Securities Industry and Financial Markets Association (**SIFMA**) is a trade association that results from the November 1, 2006 merger of the Securities Industry Association and The Bond Market Association. It brings together the shared interests of more than 650 securities firms, banks and asset managers. SIFMA's mission is to promote policies and practices that expand and perfect markets, foster the development of new products and services and create efficiencies for member firms, while preserving and enhancing the public's trust and confidence in the markets and the industry. SIFMA works to represent its members' interests in the US and globally. It has offices in New York, Washington DC, and London and is associated with the Hong Kong based Asia Securities Industry and Financial Markets Association.