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

Reply to the CESR consultation

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Summary

EuroInvestors fears that these proposed guidelines for the choice and presentation of performance scenarios will lead to very misleading information for retail investors. These performance scenarios should reflect probable or highly probable returns in order not to mislead investors and to be consistent with the EC Regulation implementing the Investment funds Directive.

Structured funds are mostly marketed to retail investors and not to institutional ones, although they are very difficult to understand both for retail investors and for the retail intermediaries who sell them. The future performance is almost impossible to assess for them, especially if no probable performance outcomes are disclosed. The imbedded profit for the manufacturer is usually secured from the start through derivatives contracts, but this is also not disclosed to the client, who knows only about the management fees which are largely irrelevant in that case, as they represent only a part of the revenue generation for the provider. This should make the financial regulators extremely wary of the information provided on these products.

Choice of the scenarios

One stated objective of the KII in the UCITS IV Directive is to enable retail investors to get a better assessment of the future performance of the fund. The proposed guidelines do not achieve this goal as the choice of performance scenarios to be presented is not clearly and explicitly driven by their probability of happening.

Moreover, this lack of probability weighting in the performance scenarios presented is not consistent with article 36 of the Commission Regulation No 583/2010 implementing the UCITS IV Directive. Indeed, article 36 requires that these scenarios:

- Be presented in a not misleading way;
- Based on reasonable and conservative assumptions;
- Include a scenario "*whenever the formula exposes investors to the possibility of substantial losses,… these losses shall be appropriately illustrated, even if the probability of the corresponding market conditions is low.*"*(art 36-, para 2)*

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These three requirements clearly imply that the scenarios chosen (except the "substantial losses" one) must be highly probable ones so as to:

- Not mislead retail investors who will most likely consider these scenarios as the most probable ones anyway (if not, why would they be communicated?) even with an accompanying statement that they are not forecasts;
- be based on conservative market assumptions, i.e. equivalent or below those that the provider used to price its fund;
- Have at least all scenarios other than the "substantial losses" one bear a medium to high probability as implicitly but clearly required by Art. 36-5, 2nd paragraph.

One other Key Investor Information document (KII) objective is to enable retail investors to compare more easily one fund product to the other. This was stated in the UCITS IV Directive on investment funds.
The stated objective of the proposed CESR guidelines is "*to ensure comparability between structured UCITS*". This is not enough. Comparability must also be ensured with the other –not structured – funds and other investment alternatives to enable retail investors to better choose the right product for their needs and objectives. The performance scenarios as presented do not enable them to do that because they do clearly and explicitly represent probable performances, and also because the equivalent risk free rate is nowhere to be found.

We also identify other inconsistencies between the guidelines and the EC Regulation 583/2010:

- The scenarios should not – according to the Regulation "*illustrate the functioning of the formula <u>in unfavorable, favorable and medium market conditions</u>*", but *"the circumstances in which the formula may generate <u>a low, a medium or a high return</u>"*, which is quite different, and implies that the KII document defines what is considered a low, medium or high return for this structured fund. A good way seems to refer to the equivalent risk free return[1] (which could constitute the medium return scenario provided it bears a medium to high probability).

- The key regulatory reference to "*<u>conservative</u>*" assumptions is omitted in the guidelines.

Presentation of the scenarios

The freedom of the providers to choose between graphs or tables will make it more difficult for investors to compare even between one structured fund using graphs and another using tables.

We are concerned about CESR's statement that in the case when the investor sells its units before the end date, the value "*will depend on the market value of the underlying assets at that time*." We believe such a statement is often misleading. Evidence shows that this is often not the case and moreover impossible to check. In these cases evidence shows on the contrary that the exit value is often set by the provider without any explanation and it is impossible for the investor to check if this value reflects the market value of the underlying assets. It would at the very least require the provider to disclose the detailed portfolio of the structured fund assets.

[1] Example: for an 8 year capital guaranteed structured fund (typical in France for example), the equivalent risk free rate could be the 8 year government bond return.