

Dated 10 September 2009



To be submitted via CESR's website www.cesr.eu

Joint Associations Committee (JAC)

Response to

**CESR Consultation Paper, together with
Addendum on technical advice at level 2 on the
format and content of Key Information Document
(KID) disclosures for UCITS dated 8 July 2009 (09-
552)**

Executive summary

This response to the CESR “Consultation paper on technical issues at level 2 on the format and content of Key Information Document (“KID”) disclosures for UCITS” 09-552 (the “Consultation”), together with the Addendum to the Consultation (the “Addendum”) 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. Members of the JAC (“Members”) have expressed particular interest in relation to the impact of the Consultation on structured funds (“Structured Funds”) and this response is, therefore, directed primarily at Section 14 and paragraphs 43 to 61 of Annex 1 of the Consultation and Section 4 of the Addendum. No inference should be made from this response concerning Members’ views on the elaboration of KID’s details, or even on the appropriateness of the KID concept itself, outside the UCITS context.²

This response focuses on the two areas of the Consultation that are of most concern to our Members: “Performance scenarios – prospective scenarios or probability tables” and “Computation of the synthetic risk and reward indicator (“SRRI”) – VaR methodology.” The JAC has received a range of views from its Members which have been reflected in the more detailed responses below. The JAC summarises below some of the salient points from our response as follows:

Performance scenarios - Prospective scenarios or probability tables (Section 14 of the Consultation)

The preference of a number of Members is that, for the purposes of the KID, prospective scenarios should be presented through the use of graphs or tables (Option A - Box 24A - of the Consultation). There was a broad consensus from Members that the alternative presented by CESR of performance 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.

Members acknowledge CESR’s view that past performance may not be appropriate for inclusion in the KID and note that the KID may need to refer to the prospectus where more detailed performance data can be presented.

¹ The JAC is sponsored by: International Swaps and Derivatives Association (**ISDA**), the International Capital Markets Association (**ICMA**) 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 metcalfe@isda.org

² Some Members are concerned, despite the current formal focus of CESR and Commission work, at the possibility of subsequent and potentially inappropriate extension of the KID concept to areas that are not unequivocally both ‘structured’ and ‘retail’.

VaR methodology (Addendum)

There was a strong consensus amongst Members on the basic principle for calculating an equivalent volatility for Structured Funds based on VaR but that VaR at maturity, coupled with an appropriate disclaimer and/or risk warning was the preferred route. 1-year VaR was thought to be of limited use to investors and raises technical and operational issues.

Full response

1 Structured funds – Section 14 of the Consultation

Members acknowledge CESR's view that past performance may not be appropriate for inclusion in the KID and note that the KID may need to refer to the prospectus where more detailed performance data can be presented.

There remains a strongly held view by some Members that certain categories of funds should not be treated differently. In particular, some Members cannot see the rationale for different treatment between market and strategy funds, on the one hand, and structured funds on the other. At present, it appears to be CESR's view that past performance charts may be used for market and strategy funds but not for structured funds; Members question why past performance (with a narrative to indicate their limited use for predicting future performance (Box 11, point 6)) is appropriate for market and strategy funds but not for structured funds. In addition, Members commented that to the extent scenario analyses are required for structured funds, they would be equally helpful in relation to market and strategy funds. A further point raised is that for structured funds that do have a significant history, Members challenge the position that past performance is not an appropriate measure. Whilst Members accept that past performance is not appropriate in all cases, some Members believe that CESR has still not provided a clear explanation as to why structured funds should be treated in a different way to other types of fund.

Section 14 of the Consultation provides two options for the presentation of performance scenarios in the context of Structured Funds:

Option A: prospective scenarios showing the return of the fund under favourable, adverse and average market conditions; or

Option B: tables showing the probability of certain defined events: achieving a negative return or achieving a positive return worse, equal to or better than the risk-free rate.

The preference of a number of Members is that Option A should be preferred. In relation to Option B, the following observations were made:

1.1 Risk neutral model

1.1.1 Option pricing

Risk neutral stochastic models are models that are used in order to price options. As option theory demonstrates, such models are appropriate 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 Hull³, 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 (...).

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.

1.1.2 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.

³ John C. Hull: Options, Futures and other Derivatives, Prentice Hall, fifth edition

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.

1.1.3 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..

1.1.4 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. 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.

The approach is difficult for regulators to implement as 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.

2 Addendum to the Consultation - Section 4: The special case of Structured Funds

CESR has proposed that the risk classification for structured funds should be calculated by taking the maximum of:

- (a) the annualised volatility corresponding to the 95% VaR at maturity; and
- (b) the annualised volatility corresponding to the 95% VaR in 1 year's time.

Strong views were expressed by the Members that annualised volatility corresponding to 95% VaR at maturity coupled with an appropriate risk warning and/or disclaimer that any data is based on the expectation that shares will be held by an investor until maturity would be a more relevant and preferable approach in the KID.

2.1 Question 7: Do you agree with CESR’s proposal concerning the methodology to compute the SRRI of structured funds? If not, please explain and, if possible, suggest alternatives.

There was strong consensus from the Members for the use of annualised volatility corresponding to VaR at maturity. 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.

However, there were strong views expressed that it is not appropriate also to calculate the volatility of 1-year VaR for the following reasons:

2.1.1 Hold to maturity investments

The Consultation recognizes that “most investors in structured funds tend to hold their investment until maturity” but proposes also to calculate 1-year VaR on the basis that investors are permitted to redeem before maturity. However, Members have pointed out that it is very unlikely that an investor would invest in a structured fund with a view to exiting before maturity. Therefore, Members proposed that any risk indicator should be based on the VaR at maturity only.

Members have suggested that the 1-year VaR measurement should be replaced with a requirement to include a specific risk warning and/or disclaimer in the KID to state that the return on the fund is based on the assumption that investors will hold their shares until maturity. Members direct CESR to the language that is already requested by the French regulator in simplified prospectuses of French structured funds: “The fund XYZ is built on the basis of an investment on the whole life of the fund. It is therefore highly recommended you purchase shares of such fund only if your intention is to keep them until maturity of the fund. If you sell such shares early (...)”⁴.

Members believe that such a disclaimer would be more helpful to investors than the current indicator suggested by the Consultation that a specific disclaimer is included to indicate, “where appropriate and relevant, that the fund might have a different (lower or higher) level of risk if the investment is held until maturity or, conversely, redeemed before that date”. Since the Consultation proposes to take the highest risk of VaR at maturity and 1-year VaR, the disclaimer would seem only to have to state that the effective risk will always be lower than the risk mentioned by the synthetic indicator. This produces an unusual result in that usually, a risk warning is included to highlight a potential added-risk if a specific event occurs whereas CESR's proposal is to include a warning that the risk will always be lower.

⁴ Official French wording : “Le fonds xxx est construit dans la perspective d’un investissement pour toute la durée de vie du fonds. Il est donc fortement recommandé de n’acheter des parts de ce fonds que si vous avez l’intention de les conserver jusqu’à leur échéance prévue. Si vous revendez vos parts avant le ... »

2.1.2 Operational and technical difficulties

The computation of VaR at maturity is not based on models, but on running the formula of the fund on the basis of past data. (e.g. $260 \times 5 = 1300$ values of the formula according to past data during 5 years). Whilst this is onerous, the Members agree that it is manageable from an operational and technical perspective.

Calculation of the 1-year VaR, as shown by the Consultation, presents some operational and technical difficulties as calculations are largely based on models. For example, calculations would need to be carried out on 1300 prices of the fund based on past data. Each price to be calculated would be a full pricing exercise and would need to be carried out 1300 times. In addition, the calculations would involve some element of subjective assessment on the part of the asset manager.

Members believe that no asset manager currently has the systems to carry out such calculations annually on each structured fund. New computing chains would have to be built and the cost for the industry may be significant. As noted above, since Members believe that the 1-year VaR data is of little value to investors they, therefore, question the cost/benefit analysis of such an approach.

2.1.3 Using only VaR at maturity would not create any advantage for Structured Funds

The formula that is used to compute the equivalent volatility takes fully into account the duration of the VaR. In other words, if the distribution of a fund is log-normal, the application of the method of Box 4 would produce an equivalent volatility equal to the historical volatility, whatever the maturity used for the calculation may be. There would be no advantage for a fund to be a Structured Fund, which would require finding an alternative means of penalising them.

2.2 Question 8: Do you agree with CESR's proposal to use VaR as an (intermediate) instrument for the measurement of volatility? Is the proposed VaR-based approach appropriate to convey correct information about the relevant return volatility of structured funds?

Members agree with such approach, provided that only VaR at maturity, coupled with a disclaimer and/or risk warning is used (see question 7).

2.3 Question 9: Do you share the view that the solution proposed by CESR is flexible enough to accommodate the specific features of all (or most) types of structured fund? If not, please explain your comments and suggest alternatives or explain how the approach could be adjusted or improved.

The solution proposed by CESR, provided only VaR at maturity is used (see question 7), is appropriate for any type of Structured Fund.

Members assume, however, that the method that is described in Box 4 will be extended to Structured Funds that are based not only, as mentioned in the example, on one index XYZ, but on several securities. If so, it should be clarified that the performance of each security will be calculated for each of the week of the sample, and then, for each week, a simulated return at maturity of the fund will be computed.

2.4 Question 10: Do you agree with CESR's proposal concerning the methodology to compute the VaR-based volatility of structured funds over a holding period of 1 year? If not, please explain your comments and suggest alternatives.

As explained above in our answer to question 7, Members do not, broadly, agree that a 1-year VaR should be calculated. As an alternative, Members propose including a risk factor that the data provided is based on the assumption that investors will hold their share in the Structured Fund until maturity and that significantly different returns would be applicable should they decide to redeem their shares prior to such time.

2.5 Question 11: Do you agree with CESR's proposal concerning the methodology to compute the VaR-based volatility of structured funds at maturity? If not, please explain your comments and suggest alternatives.

Members generally agreed on the method.

2.6 Question 12: Do you agree with CESR's decision not to promote further the adoption of the delta representation approach for the computation of volatility of structured funds?

Members generally agreed, provided that the 1-year VaR approach is abandoned. Some Members expressed the view that the delta representation approach made more sense than the use at the same time of the 1-year VaR and the VaR at maturity. However, the disadvantages are that the delta approach does not take into account the investment horizon and is also heavily model dependant.

2.7 Question 13: Do you share the view that CESR's current proposal represents an improvement with respect to the delta representation approach? If not, please clarify why you believe that the delta representation approach may be more suitable to estimate the volatility of structured funds.

Members broadly do not share this view: some Members believe that the delta approach is too simple because it does not take into account the horizon of the fund. However, since the simultaneous use of the 1-year VaR and the VaR at maturity would yield some irrational results, it is less preferable to the delta approach.

2.8 Question 14: Do you consider it possible and appropriate to allow the use of Monte Carlo simulations for the computation of the SRRI of structured

funds? If yes, please explain whether these methods are more suitable for the computation of VaR or, directly, for that of volatility measures.

Monte Carlo simulations are risk neutral simulations which, arguably, do not provide a useful risk measure. Some Members argued that only simulations based on past performance, as proposed by CESR, can give a view of the real risks. In addition, Monte Carlo simulations would introduce a discrepancy between Structured Funds and other funds, where the SRRI is computed based on historical volatility. Such simulations would also be difficult to calculate and model and are parameter dependent, thereby introducing some degree of discretion on the part of the asset manager.

2.9 Question 15: Do you believe that it would be possible to avoid significant differences in the outcome of such simulations across management companies? What should be the key methodological requirements needed to avoid such divergences?

VaR at maturity is believed to be an objective data, which would not depend on models, and therefore does not rely on subjective assessments by the asset manager. However, 1-year VaR can be calculated only using pricing models and pricing parameters which will not be identical across asset managers; many pricing parameters, like correlations, do not have public prices and would introduce discretion on the part of the asset managers.

3 VaR as a measure across all funds

Views were expressed that generally VaR is a more reliable risk measure for measuring risks across all Structured Funds and should, therefore, be used in preference to the current volatility measures proposed. In particular, volatility requires a scale in order to be interpreted which necessarily acknowledges the inherent flaws in its methodology. VaR is seen by some Members to be more readily understood by investors and likely to create a more level playing field across the wider spectrum of funds.

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.



ICMA

ICMA is a unique self regulatory organisation and an influential voice for the global capital market. It represents a broad range of capital market interests including global investment banks and smaller regional banks, as well as asset managers, exchanges, central banks, law firms and other professional advisers amongst its 400 member firms. ICMA's market conventions and standards have been the pillars of the international debt market for over 40 years, providing the self regulatory framework of rules governing market practice which have facilitated the orderly functioning and impressive growth of the market. ICMA actively promotes the efficiency and cost effectiveness of the capital markets by bringing together market participants, including regulatory authorities and governments.