

Structured Thoughts

News for the financial services community.



In this issue, we discuss the new disclosure document to be introduced in the EEA, called the Key Information Document, and also CESR's technical advice to the European Commission in relation to the implementing measures. Additionally, we briefly summarise the feedback and practical responses from industry associations, such as the Joint Associations Committee on Structured Products.

Retail Investor Disclosure Under the New UCITS KID

Background to UCITS IV and the New KID

Since 2005, the European Commission (the "Commission") has undertaken an extensive review of the EU framework for retail investment funds, including, in particular, undertakings for collective investment in transferable securities ("UCITS").

In March 2007, the Commission launched a public consultation on possible targeted adjustments to key areas of the regulatory framework under the existing UCITS directive (85/611/EC) ("UCITS III"), including, in particular, the effectiveness of the existing disclosure regime for UCITS, the principal requirement of which is the publication of a "simplified prospectus" relating to the relevant investment.¹

Following the completion of such consultation process, on 22nd June 2009 the EU Council formally adopted a revised UCITS directive ("UCITS IV") making material changes to UCITS III. The final text of the new directive was

¹ European Commission Working Document (consultation paper): Initial orientations for possible adjustments to UCITS Directive: Overview of key features (22nd March 2007), http://ec.europa.eu/internal_market/investment/docs/legal_texts/orientations/overviewexposure_en.pdf (closed 15th June 2007); Exposure draft 5: Simplified prospectus – Investor disclosure regime, http://ec.europa.eu/internal_market/investment/docs/legal_texts/orientations/prospectusexposure_en.pdf.

published in the Official Journal of the European Communities on 17th November 2009² and must be implemented by all EEA member states by 1st July 2011. Amongst the most important changes in the new directive is the replacement of the requirement to produce a simplified prospectus with a new disclosure document called the Key Information Document (“KID”).³

We set out below the new disclosure regime, which will be introduced in the EEA with the introduction of the KID, including CESR’s technical advice to the Commission in relation to the implementing measures. In addition, we briefly summarise the feedback and practical responses from industry associations, such as the Joint Associations Committee on Structured Products (“JAC”).

Disclosure of Key Investor Information (“KII”) Under New UCITS Directive

The simplified prospectus, which was introduced by the Management Company Directive (2001/107/EC) in 2002, has been widely criticised for being unhelpful to retail investors (in particular, for being too long and too complex), for the lack of transparency (especially as to costs and risks) and for being subject to varying disclosure standards among different EU member states.

Therefore, the Commission has proposed to replace the simplified prospectus with a new KII, which is designed to improve the quality and the usefulness of UCITS product disclosures provided to retail investors, and to harmonise an EU-wide approach to pre-contractual disclosures.

The regulatory aim and parameters of the new KII are contained in Articles 78 – 82 of UCITS IV.

Objective

Article 78(2) states that the KII shall include “appropriate information about the essential characteristics of the UCITS concerned, which is to be provided to investors so that they are reasonably able to understand the nature and the risks of the investment product that is being offered to them and, consequently, to take investment decisions on an informed basis.”

Contents

To this aim, Article 78(3) provides that the KII must contain, as part of its *contents*, the following “essential elements” in respect of the UCITS concerned:

- identification of the UCITS;
- a short description of its investment objectives and investment policy;
- past-performance presentation or, where relevant, performance scenarios;
- costs and associated charges; and
- the risk/reward profile of the investment, including appropriate guidance and warnings in relation to the risks associated with investments in the relevant UCITS.

Finally, the KII must specify how investors can obtain additional information, such as the relevant prospectus and the annual and half-yearly reports. However, these essential elements included in the KII must be understandable to the investors without reference to other documents.

² Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) (recast), <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:302:0032:0096:EN:PDF>.

³ See, e.g., Morrison & Foerster client alert: CESR Consultation Paper on UCITS Management Company Passport (24th October 2008), <http://www.mofo.com/files/Publication/3cc6c3bc-a774-4c4f-a48f-33a840f1eff5/Presentation/PublicationAttachment/5706cff7-0570-4623-a1cb-da040192e456/081024CESR.pdf>.

Format

In relation to the *format* in which the essential elements are required to be presented, Article 78(5) states that the KII shall be “written in a concise manner and in non-technical language, drawn up in a common format, allowing for comparison, and...presented in a way that is likely to be understood by retail investors.”

Level 2 Implementing Measures Concerning the Format and Content of KID, Including Proposed Methodologies

Commission’s request to CESR for technical advice on the new UCITS Directive implementing measures (13th February 2009)⁴

Article 78(7) of UCITS IV mandates the Commission to adopt implementing measures that define:

- the detailed and exhaustive *content* of the KII, including those for specific types of UCITS, such as umbrella funds, unit/share classes, fund of funds, master-feeder structures and structured funds; and
- the specific details of the *format* and *presentation* of the KII.

Accordingly, on 13th February 2009, the Commission issued a request to CESR for technical advice on the implementing measures to ensure smooth and effective operation of UCITS IV, Part II of which was focused on the KII. The other parts (I and III) covered the management company passport, fund mergers, master-feeder structures and the notification procedure.

In turn, on 17th February 2009, CESR issued a call for evidence on possible implementing measures for the proposed UCITS IV, in which it invited feedback from market participants until 31st March 2009.⁵ In the call for evidence, CESR proposed that the KII disclosures for UCITS be made in a key information document to be known as the KID.

CESR’s initial proposals in its consultation paper on technical issues relating to KID Disclosures for UCITS (16th March 2009)⁶

CESR had previously provided advice to the Commission on the content and form of KII disclosures for UCITS in February 2008,⁷ wherein it identified certain technical issues as meriting further consideration, categorised under the three key KII disclosure headings below.

The 16th March 2009 consultation set out CESR’s initial proposals on these technical issues for feedback from market participants, as follows:

1. *Risk and reward*: Two options as identified in the February 2008 advice: either (i) an improved version of the narrative approach, or (ii) a numerical Synthetic Risk-Reward Indicator (“SRRI”) figure, applying a harmonised calculation methodology (to be developed).

⁴ European Commission’s Provisional Request to CESR for Technical Advice on Possible Implementing Measures of the Future UCITS Directive (13th February 2009), http://ec.europa.eu/internal_market/investment/docs/legal_texts/ta_mandate_en.pdf. The request was called “provisional” in that the new Directive has not yet been adopted and is thus still open to some adjustments to its final text. See also, the related Letter from the European Commission to CESR (13th February 2009), http://ec.europa.eu/internal_market/investment/docs/legal_texts/ta_letter_holmquist_en.pdf.

⁵ CESR Call for Evidence on Possible Implementing Measures of the Future UCITS Directive (17th February 2009), <http://www.cesr.eu/popup2.php?id=5570> (closed 31st March 2009).

⁶ CESR consultation paper: Technical issues relating to Key Information Document (KID) Disclosures for UCITS (16th March 2009), <http://www.cesr.eu/popup2.php?id=5643> (closed 15th May 2009).

⁷ CESR Advice to the European Commission on the Content and Form of Key Information Document Disclosures for UCITS (15th February 2008), <http://www.cesr.eu/popup2.php?id=4955>. See also, CESR Consultation Paper on Content and Form of Key Investor Information Disclosures for UCITS (16th October 2007), <http://www.cesr-eu.org/popup2.php?id=4814>.

2. *Past performance*: Either (i) past performance disclosures – for funds with past performance data, or (ii) performance scenarios – for structured funds or formula funds where no meaningful past performance data is available.
3. *Charges*: Disclosure of charges should cover:
 - the “illustration of charges” approach using cash figures instead of percentages;
 - the harmonisation of the ongoing charges calculation;
 - performance fees;
 - portfolio transaction costs;
 - new funds; and
 - material changes in the charging structure.

CESR’s draft Level 2 advice in its consultation paper (8th July 2009) and addendum (4th August 2009) on technical advice relating to the format and content of KID⁸

On 8th July 2009, CESR published another consultation paper setting out its draft Level 2 advice to the Commission on the format and content of KII disclosures for UCITS, followed by an addendum on 4th August 2009, wherein it detailed the rationale for its draft advice concerning the proposed SRRRI methodology, and recommended that respondents also take the information into account when providing their feedback.

In relation to the content of the disclosure to be made in the KID, CESR made the following proposals:

- *Objectives and investment policy*: The KID should describe these clearly rather than repeat the description in the relevant prospectus; and (by way of clarification) make a statement to the effect that investors may redeem their units on request.
- *Risk and reward profile*: CESR outlined the two options under consideration mentioned above but indicated its preference for a SRRRI supported by a narrative approach and stated that it intended to work on the supporting methodology, to be published in July 2009 for consultation.

In Annex 1 to the consultation paper, CESR presented a working model of the specific methodology for computing the SRRRI, subject to further refinements in respect of:

- the definition of upper and lower boundaries for the volatility of the returns (i.e., the past performance); and
- the detailed risk classification process for structured funds.
- *Costs and associated charges*: Having considered a range of options, CESR’s draft advice proposed (i) a table setting out the different elements of the charging structure (in percentage terms), to be accompanied by (ii) a simple summary measure of charges (in narrative terms), including a cash figure.

CESR Level 2 technical advice to the Commission concerning the format and content of KID (28th October 2009)⁹

On 28th October 2010, CESR submitted its Level 2 technical advice to the Commission, which contained the following recommendations.

⁸ CESR Consultation Paper on CESR’s Technical Advice at Level 2 on the Format & Content of Key Information Document Disclosures for UCITS (8th July 2009), <http://www.cesr.eu/popup2.php?id=5789>; and Addendum to CESR’s consultation paper on the Format & Content of Key Information Document (KID) Disclosures for UCITS (Ref: CESR/09-552) (4th August 2009), <http://www.cesr.eu/popup2.php?id=5873> (the consultation closed 4th September 2009).

⁹ CESR’s Technical Advice to the European Commission on the Level 2 Measures related to the Format and Content of Key Information Document disclosures for UCITS (28th October 2009), <http://www.cesr-eu.org/popup2.php?id=6149>.

1. *Format*: The pre-contractual disclosure provided to investors in the KID must:

- be short, concise and written in plain language
- be limited to two pages of A4 paper for vanilla funds and slightly longer (three or four pages) for structured funds
- contain “only the key elements of information investors need before making a decision on whether to invest in a fund”

2. *Content*:

- *Risk-Reward Indicator profile*: The KID should include a SRRRI of the fund's volatility on a numerical scale of one to seven, accompanied by a narrative text covering the material risks more fully.
- *Charges*: The KID should include a table clearly setting out different elements of the charging structure (relevant percentages).
- *Past performance*: This must be disclosed based on the “use of a bar chart displaying up to 10 years’ past performance, where available,” but at least one full year’s data.
- *Optional performance scenario analyses for structured funds*: CESR proposed, as an alternative to past performance, that the KID illustrate the fund's potential performance using potential scenarios arising under a range of market conditions.

The Commission has also announced that it intends to use the UCITS IV requirements for KID contents as a benchmark in developing better disclosure standards for the wider retail investment product markets (such as other packaged retail investment products), whilst respecting the differences in product features.¹⁰

CESR’s Level 2 technical advice to the Commission concerning fund mergers, master-feeder structures and cross-border notification, as well as two methodologies for KID (22nd December 2009)¹¹

On 22nd December 2009, CESR published its further technical advice to the Commission on Level 2 measures relating to fund mergers, master-feeder structures and cross-border notification of UCITS (Part III of the mandate). It also recommended the following two methodologies relating to the format and content of KIDs:

- the methodology for the calculation of the SRRRI; and
- the methodology for the calculation of the ongoing charges.

This advice formed the final elements in CESR’s Level 2 advice to the Commission on the Level 2 implementing measures for the KID under UCITS IV.

CESR Feedback Statement¹² ***on the responses received to its consultation paper (8th July 2009) and addendum (4th August 2009) on its technical advice relating to the format and content of KID***

On 19th April 2010, CESR finally published its feedback statement on the responses it received to its July 2009 consultation paper (including the August 2009 addendum).

¹⁰ See Morrison & Foerster client alert: An update on the EU actions on PRIPs (10th February 2010), http://www.mofo.com/files/Publication/f17b0cf1-4d0f-469a-955d-e48fe44565bd/Presentation/PublicationAttachment/a7aa0212-967d-4490-940d-ff237efc43b8/100210Structured_thoughts_issue_3.pdf.

¹¹ CESR’s Technical Advice to the European Commission on the Level 2 Measures relating to mergers of UCITS, master-feeder UCITS structures and cross-border notification of UCITS (22nd December 2009), <http://www.cesr.eu/popup2.php?id=6359>, and the related Annex: Methodology for the calculation of the synthetic risk and reward indicator <http://www.cesr.eu.org/popup2.php?id=6361> and Annex 2: Methodology for calculation of the ongoing charges figure, <http://www.cesr.eu.org/popup2.php?id=6360>.

¹² CESR Feedback Statement: CESR’s technical advice to the European Commission on the format and content of Key Information Document disclosures for UCITS (19th April 2010), <http://www.cesr.eu/popup2.php?id=6565>.

CESR reported that the responses had been broadly supportive of its proposals. Specifically it confirmed its decision to confirm its previous proposals as follows:

- *Risk and reward:* These must be indicated through a SRRI figure, supported by a narrative explanation.
- *Charges:* The KID must include a table setting out the different elements of the charging structure in percentage terms (rather than in cash figures).
- *Performance:* Past performance must be disclosed using a bar chart displaying up to 10 years' past performance, except in the case of structured funds (such as formula funds, capital-protected funds and other comparable UCITS) where prospective scenarios showing the returns under "favourable, adverse and average market conditions" must be provided.

Next steps

The Commission has stated that it intends to adopt by 1st July 2010 the final Level 2 implementing measures, well ahead of the 1st July 2011 deadline by which all EEA member states must implement the new UCITS directive.

Those measures are expected to be based on the technical advice provided by CESR on 28th October and 22nd December 2009, as well as the consumer testing exercises, which were carried out from March to June 2009.¹³

Industry Responses to CESR Technical Advice and Ongoing Development of the Template KID

JAC response to CESR consultation on Level 2 measures for the UCITS KID format and content (10th September 2009)¹⁴

JAC is an industry representative body, which is comprised of the European Securitisation Forum ("ESF"), International Capital Market Association ("ICMA"), London Investment Banking Association ("LIBA"), International Swaps and Derivatives Association ("ISDA") and Securities Industry and Financial Markets Association ("SIFMA"). As such, it has been actively involved in the dialogue with both the Commission and CESR during their respective public consultations and call for evidence concerning the proposed changes to the UCITS directive, including the requirements of the new KID.

On 10th September 2009 the JAC members submitted the following specific comments on the CESR proposals in relation to structured funds:

1. *Past performance presentation:* As CESR stated in its consultation paper, past performance may not be appropriate for inclusion in the KID; instead, the KID – for both UCITS and certain other funds – may need to refer to the prospectus for more detailed performance data. However, CESR should still clarify why it proposes to treat structured funds differently from market and strategy funds.
2. *Risk/reward profile:*
 - JAC members believe that Value at Risk ("VaR") is a more reliable measure of risks across all structured funds, rather than the delta representation approach. VaR would be easier for investors to understand and is more likely to help create a level playing field across a wider spectrum of funds.
 - The JAC strongly supports the use of annualised volatility corresponding to VAR at maturity, which it believes should be applied across all types of funds.

¹³ UCITS Disclosure Testing Research Report, prepared for the Commission by IFF Research and YouGov (June 2009), http://ec.europa.eu/internal_market/investment/docs/other_docs/research_report_en.pdf.

¹⁴ JAC Response to the CESR Consultation Paper, together with Addendum, on technical issues at Level 2 on the format and content of Key Information Document (KID) disclosures for UCITS dated 8 July 2009 (09-552) (10th September 2009), http://www.isda.org/c_and_a/pdf/KID-disclosures-for-UCITS-JACresponse.pdf.

- The JAC is, however, critical of CESR's proposal concerning the risk classification of structured funds. In particular, it believes that the risk should be calculated by reference to annualised volatility corresponding to 95% VaR at maturity (an objective data), and (contrary to CESR's proposals) not by reference to a one-year VaR (which would inevitably involve different pricing models and pricing parameters among different asset management companies), on the basis that most structured fund investors tend to hold the investment until maturity (and include a risk warning as to this assumption).
- In disagreement with CESR, the JAC believes that the theoretical, risk-neutral model (such as Monte Carlo simulations) should not be applied in relation to options pricing. The KID should instead provide investors with a "real world" risk/reward profile. Furthermore, it believes that a risk-neutral analysis should either be applied or disappplied equally to both structured and other funds.

Development of the template KID

In addition to commenting on CESR's proposals, JAC is in the process of developing a template KID document for use across not only UCITS funds but other retail investment products.

Following discussions among the JAC members, the JAC set out, in a memorandum dated 17th March 2010, the basis on which a pro forma template will now be prepared.¹⁵ The memorandum pointed out that the KID will be a "key marketing document" for retail investors that presents "a product overview consistent with the Base Prospectus but does not supersede the detailed terms and conditions." In relation to the format and content, the memorandum highlighted that there have been two recurring themes, i.e:

- general opposition to the inclusion of a numeric risk indicator (SRRI); and
- general support for the inclusion of (i) a section explaining why an investor may wish to purchase the product, and (ii) an option to include scenario analyses.

On 29th April 2010, JAC published and circulated a draft template KID document and accompanying reading note,¹⁶ inviting written comments from its members by 14th May 2010. JAC intends to call for a meeting to discuss the draft template KID in due course.

Joint ABI/IMA research briefs (March 2010)

On 19th March 2010, the Association of British Insurers ("ABI") and the Investment Management Association ("IMA") published two joint research briefs assessing two main aspects of CESR's recommendations, namely, the proposed risk categories and the applicable time scale for computing the SRRI.¹⁷

ABI and IMA argued that CESR's proposed SRRI methodology, whereby each fund would calculate the SRRI figure based on five years' historical volatility, was flawed. According to their research, the methodology could be improved by basing the risk indicator on the volatility of the underlying asset classes (which would help avoid excessive "bunching") rather than on the funds, and a longer historical volatility data (which would result in more stable ranking over time) should be used.

Conclusion

As we have highlighted above, despite significant amount of work on the part of EU regulators and market participants, the precise requirements of the KID document are yet to be determined, although most of the general

¹⁵ JAC KID – An Outline Approach (17th March 2010), http://www.isda.org/uploadfiles/docs/JAC_KID_An_Outline_Approach.pdf.

¹⁶ European Commission Working Document (consultation paper): Initial orientations for possible adjustments to UCITS Directive: Overview of key features (22nd March 2007), http://ec.europa.eu/internal_market/investment/docs/legal_texts/orientations/overviewexposure_en.pdf (closed 15th June 2007); Exposure draft 5: Simplified prospectus – Investor disclosure regime, http://ec.europa.eu/internal_market/investment/docs/legal_texts/orientations/prospectusexposure_en.pdf.

¹⁷ Key Investor Information Document (Draft 15.04.10),

<http://www.isda.org/uploadfiles/docs/100429ICM10226862v2ReadingnotesforthedrafttemplateKID1004.doc>; Reading notes for the draft template JAC KID, <http://www.isda.org/uploadfiles/docs/ICM10226425v2KeyInvestorInformationDocument1004.DOC>.

principles appear to have been established. Before the Commission can adopt the relevant implementing measures, however, there still remain contentious technical issues to be resolved, particularly in relation to the disclosure of the risk/reward profile and performance data and how structured funds are to be treated.

Contacts

Peter Green
+44 20 7920 4013
pgreen@mofo.com

Helen Kim
+44 20 7920 4147
hkim@mofo.com

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