UCITS IV: Time for change
The Asset Management Industry’s views on the Key Information Document

June 2010
Foreword by PwC and EFAMA

In the course of summer 2010, Europe’s asset managers will learn the final form of the most extensive regulatory upheaval they have faced in many years.

Whilst at different stages in the legislative process, UCITS IV and the Alternative Investment Fund Managers directives will be implemented by the EU.

Within UCITS IV, one of the few compulsory measures is the Key Information Document (KID), which on the face of it appears straightforward. Yet the KID has far more wide-reaching implications than asset managers currently realise.

Our survey canvassed a broad cross section of managers, and it clearly shows that many have not yet understood the KID's significance. Most strikingly, 58% of respondents had not considered the cost implications of changes to their systems and controls to implement the KID.

In fact, large asset managers may need to produce thousands of KIDs each year. The KID will, in all likelihood, have to be prepared at the share-class level, meaning the number of documents to be produced and disseminated will increase significantly compared to the simplified prospectus. Furthermore, the KID contains new requirements which the fund managers will have to comply with. As a result, managers need to start urgently planning to adapt their operations and systems accordingly.

Beyond this, the KID may also change the way in which funds are perceived. Retail investors may start to differentiate between products on the basis of the new risk indicators, leaving some managers with gaps in their product ranges. Managers would ideally want to promote funds covering the entire risk spectrum.

UCITS IV was conceived to introduce a level playing field for fund distribution across Europe, yet with tax and regulatory differences remaining within countries its measures can not have full impact. Through this survey and our respective activities, PricewaterhouseCoopers (PwC) and EFAMA are working hard to help asset managers to anticipate how they can best prepare.

We will be carrying out two more surveys to solicit asset managers’ views and to judge their levels of preparedness. The first of these will review the Management Company Passport, and will be published in September.

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Executive summary

This is the first in a series of surveys that PwC, in conjunction with EFAMA, will be conducting in relation to the implementation of the UCITS IV Directive.
The objective of these surveys is to ascertain the intentions of the Asset Management industry and the challenges it faces with regards to:

- The new UCITS requirements related to the Management Company Passport;
- The new Key Information Document that will replace the existing Simplified Prospectus; and
- The restructuring toolkit that allows asset managers to pool their assets by merging their European investment funds on a European basis and/or adopting master-feeder structures.

This document analyses the responses that were received in relation to the Key Information Document (KID). The findings demonstrate that the industry has not yet fully assessed the implications relating to the production of the KID and many requirements surrounding its production are deemed challenging.

We set out below the most critical themes, issues and implications the Asset Management industry faces in light of the requirement to produce the KID.

1. The KID is deemed to be a step in the right direction in providing investors with consistent and comparable information to make sound investment decisions; although 60% of the respondents are concerned the level of detail may not be sufficient.

2. The Asset Management industry is not confident that the KID will help create a level playing field for funds within Europe through providing comparable and consistent investment information.

3. 54% of respondents believe that the KID will provide the investor with a better understanding of a product's risks and rewards.

4. 76% of the respondents do not think that the use of a synthetic risk indicator works for all types of UCITS.

5. 50% of the respondents believe that civil liability will be applicable to the KID disclosures, a further 25% being unsure.

6. 58% of respondents have not considered the cost implications of changes to their systems and controls to implement the KID.

7. Investment management companies have identified many KID requirements that they believe are challenging.
Introduction

One of the changes under UCITS IV will be the replacement of the Simplified Prospectus for UCITS with the Key Information Document (KID). The KID is intended to be a concise and focused presentation of information for prospective investors of UCITS funds.
The UCITS IV Directive states that:
“Key investor information shall include appropriate information about the essential characteristics.....to be provided to investors so that they are reasonably able to understand the nature and the risks of the investment product.....and, consequently, to take investment decisions on an informed basis.”

Recommendations from the Committee of European Securities Regulators (CESR) on the Level 2 measures covered a number of areas of the KID, including:

- The description of the strategy and objectives of the fund should be combined in a single section of the KID and written in plain language;
- The risk and reward disclosure should be presented via a synthetic risk and reward indicator (SRRI) accompanied by a narrative explanation;
- Past performance information should be presented in a bar chart, using percentages and covering a period of up to 10 years;
- KIDs should be compulsorily published on two pages of A4-sized paper (i.e. the front and back of one sheet of paper); and
- KIDs should be updated at least once a year, within 35 business days after 31 December each year.

PwC and EFAMA asked key players in the industry, ranging from fund houses to asset servicing groups, to participate in this survey. The findings demonstrate that the industry has not yet fully assessed the implications relating to the production of the KID and many rules are deemed challenging.

The following pages provide analysis of the results of the survey representing the Asset Management industry’s view.
The KID is deemed to be a step in the right direction in providing investors with consistent and comparable information to make sound investment decisions; although 60% of the respondents are concerned the level of detail may not be sufficient.
One of the aims of the KID is to create a level playing field for providing fund information throughout Europe in order to help investors make informed investment decisions. The majority of survey respondents believe that the KID goes some way to achieving these aims. Indeed, over 70% of respondents believe the KID will help investors to assess, understand and compare products.

The KID versus the Simplified Prospectus

Respondents were asked how they would rate the KID compared to the Simplified Prospectus. Over 80% of survey respondents believe that the KID will be either much better or better.

Amongst those who believe the KID will be an improvement in comparison to the Simplified Prospectus, there was a view that the KID would be a “useful tool for comparative purposes”. However, a not uncommonly expressed view was that whilst the Simplified Prospectus “was an initiative that worked well in theory...in practice, after regulators and lawyers expanded it, it became bloated and excessively complicated.”

Will the KID provide sufficient detail for sound investment decisions?

Whilst it is the case that the majority of the survey respondents believe the KID will help investors make sound investment decisions, there were also a number of concerns over whether the two pages of the KID will be sufficient to give all the information they need to make sound investment decisions: 60% of respondents believe that the KID will not achieve this. The major concerns include:

- The limited content and length may present a challenge in disclosing all of the necessary information.
- The KID will be able to offer a good overview of products, but to fully understand their strategy it is likely to need further marketing support.
- With increasingly complex UCITS III products, it will be a challenge to explain them in such brevity.
- The level of detail required will depend on the sophistication of the potential investor.

The views highlighted above demonstrate that there are concerns around whether or not the KID can provide investors with all the relevant details necessary to make sound investment decisions. A further concern exists around the quality and the relevance of the information disclosed in the KID. There is a mixed view over whether the KID delivers greater transparency over fund management charges and products risks and rewards – this is further analysed on page 13.

Concluding thoughts

Even though the KID is more likely to be read by potential investors than the Simplified Prospectus, it is thought that “only by referring to the full prospectus, will the investor have all the information on a fund”.

Additionally, a view given by several respondents indicated that a more modern approach to providing investment information and enhancing comparability should be taken. “A central internet comparison site where investors could go to compare a number of funds for free with the costs being borne either by the investment managers or the funds themselves” was at the heart of this solution.
The Asset Management industry is not confident that the KID will help create a level playing field for funds within Europe through providing comparable and consistent investment information.
The UCITS IV directive aims to provide investors with consistent information on UCITS funds across Europe via the introduction of the KID – this, among other factors, could help create a level playing field across Europe.

**Will the KID look the same in every European Member State?**

Just less than 50% of the respondents believe that the KID will look the same, no matter what the European country of origin. Even though many respondents are “hopeful”, or feel that “it would be helpful if the KID did look the same”, they are not confident that this aim will be achieved. A view held is that there are stylistic differences between different countries and that even though there are guidelines on the main points that need to be included, fund managers will use discretion in “how these are laid out and how the numbers are derived”.

**A level playing field in Europe?**

When asked whether the consistency of information provided by the KID will help create a level playing field for funds within Europe, the views of respondents were mixed. Only 45% of the respondents thought it was likely or very likely, that this would be the case, and 30% felt it was quite or very unlikely.

There is uncertainty in the marketplace over the effectiveness of the KID. This is highlighted through the widespread results, and the varying comments made by the respondents.

Although the KID will be a “force for consistency”, non comparable information across funds in Europe is not the sole factor creating the unlevel playing field across Europe with regards to UCITS funds. Rather it is the “harmonisation of marketing and taxation rules across funds”, as well as a consistent set of regulations and standard applications across the Member States that would help create and promote this level playing field. In addition, it is believed that access is the key to levelling the playing field. More coordination between regulators would unfortunately not solve all the issues around marketing and taxation.

**Concluding thoughts**

There appears a level of uncertainty within the asset management industry as to whether the aims of the KID will be achieved in providing identical information on funds across European member states. We believe that due to the prescriptive nature of the disclosure requirements for the KID, and the fact that these requirements need to be met within 2 pages of text and diagrams that it is likely that the KID will be a fairly standard document, no matter its country of origin. Nevertheless, a standardised document to compare funds can only go so far in creating a level playing field across UCITS funds in Europe.
54% of respondents believe that the KID will provide the investor with a better understanding of a product’s risks and rewards.
A major objective of the proposed KID is to provide greater transparency to investors over the management charges and risk and reward features of a fund. To that end, the Directive prescribes that the following information on a fund is disclosed in the KID:

- its strategy and objectives;
- its risks and rewards expressed through a synthetic risk and reward indicator (SRRI) and narrative explanations;
- its charges, including entrance and exit, ongoing and contingent charges; and
- performance data for the past 10 years

However, the results of the survey suggest that there is mixed opinion over whether the KID will be able to deliver on its objective.

### Risks and reward

The SRRI will be the key metric to determine and disclose a UCITS funds risk profile. Whilst 54% of survey respondents agree that the KID will provide the investor with a better understanding of a product’s risks and rewards, still a large proportion of the respondents were still either unsure or disagreed with this.

Those expressing concern seem to base this on the view that “risks and rewards of funds can only be fully understood by sophisticated investors” and that “it depends on an investor’s knowledge of investment risk”. Many expressed a view that the SRRI, the key measure of risk, may actually be misleading and not easily understood by retail investors.

### Management charges

Only 41% of the respondents believe that the KID will deliver greater transparency around management charges.

This stems largely from the belief that the information to be disclosed in the KID will be the same as that currently available, as “figures will not differ from what is currently in the [simplified] prospectus”. Respondents do not seem to think that “the detail differs that much from what is currently shown”.

### Concluding thoughts

There is a view that there will be little difference between the management charge disclosures in the KID as compared to the simplified prospectus. Investors seeking further information on management fee charges can readily access this information currently through various sources, such as fact sheets, financial statements and the Simplified Prospectus. However, the KID will assist in ensuring consistent disclosures enabling comparisons between different funds.

Concerns over the SRRI have been well publicised to date. We discuss this further in the next section.
76% of the respondents do not think that the use of a synthetic risk indicator works for all types of UCITS.
The Committee of European Securities Regulators (CESR) guidance on the KID asks for a UCITS’s risks and rewards to be expressed through a synthetic risk and rewards indicators ranging from 1-7. The risk figure is to be calculated on the fund’s historic volatility using five years of data. The risk rating needs to be reviewed over the life cycle of the fund and the KID needs to be updated every time the rating changes.

This methodology of determining risk applies equally to traditional relative return funds, absolute or total return funds, and even structured products.

**Appropriateness of a synthetic risk indicator**

76% of the respondents do not think that the use of a synthetic risk indicator works for all types of UCITS.

The concerns included the following:

- There are “a multiplicity of risks in investing and one measure cannot possibly catch them all”.
- There is a risk that determining and disclosing the synthetic risk indicator may become “an exercise in ticking a box to meet a regulatory requirement”.

**Accurate expression of funds’ risk through a synthetic risk rating?**

Nearly a third of the respondents feel “not very confident” or “not confident at all” that they could provide an accurate risk rating for a fund’s risk through a numerical rating system of 1-7.

However, accuracy is not the only concern. Respondents are concerned about comparability; i.e. will the competition use the same methodology to determine the risk factor. “As we will not be privy to how other investment houses are rating their funds, we will not be able to ensure that we are consistent with them”. There is also a concern that there will be significant bunching of funds into a few risk categories and initial research would seem to indicate that this is likely to be the case. Some respondents believe at the time of the survey that SRRI is just one indicator of risk and that it will show “relative rather than absolute risk in practice”. Finally, the SRRI may not link to performance: “A level 1 fund could still perform worse than a level 7 fund depending on which particular market conditions were prevalent”.

However, on the flip side, there are those that feel somewhat confident (46%) or very confident (8%) about their ability to determine an accurate risk rating through the proposed rating system.

**Concluding thoughts**

The synthetic risk indicator seems to be the most discussed requirement of the KID. The concern is that not all investors will understand how the risk indicator was determined. Current thinking also indicates concern that the majority of funds will end up within two to three of the risk categories – making comparisons difficult.

Additionally, recent history has demonstrated how quickly risks can change and how a changing economic environment can change the perception of risk. The risk rating may give false comfort to investors, as the rating cannot be assessed in isolation but needs to be reviewed in the context of the environment, the investor’s risk appetite and their investment portfolio. However, are all investors sufficiently sophisticated to make their own personal assessment?
50% of the respondents believe that civil liability will be applicable to the KID disclosures, a further 25% being unsure.
The Directive calls for greater transparency and the use of non-technical language in the KID.

Use of non-technical language in the KID versus the fund prospectus

The UCITS IV Directive states that claims for civil liability cannot be based solely on the KID unless it is misleading, inaccurate or inconsistent with the relevant parts of the prospectus.

Whilst this should provide comfort for asset managers, the concern that liability may be attached generally arises from doubts over the ability to ensure consistency with the prospectus given the constraints around the content and format of the KID. “It will be difficult to ensure that there are no differences between the KID and the prospectus unless the latter is rewritten” to be consistent with the wording of the KID.

The real challenge will be for those complex funds where the prospectus contains investment objectives that are wordy or formula driven. How will these be transposed into several lines and the non-technical language required by the KID?

Only half of the respondents think that the wording in the fund prospectus will not have to be simplified to ensure consistency with the KID.

Respondents believe that for the KID to fulfill its purpose, investors need to be able to rely on the information provided in it. There is concern that should the performance fail to be as expected based on the risk profile, the fund manager would need to “explain the perceived misleading information in the KID”.

A more radical view held is that fund houses “usually make the commitment to publish reliable information and agree to be liable for it”.

Concluding thoughts

As investors are likely to rely on the information disclosed in the KID, this raises the question as to how fund houses will ensure they can deliver on their commitment to provide accurate information.

Time is limited to ensure they have appropriate resources and effective processes and controls to ensure the production of accurate KIDs on a timely basis. Further complexities arise when the fund house has outsourced the fund accounting or performance measurement to a third party, as they will have to rely on these third parties to provide the relevant information.

Asset Managers may involve further internal resources such as internal audit or may seek external comfort from their auditors or other third parties.

Liability in respect to the KID

Given the challenges described above, it is not surprising that 50% of respondents are concerned about the possibility of civil liability being applicable to the KID disclosures, despite what is written in the UCITS IV Directive.
58% of respondents have not considered the cost implications of changes to their systems and controls to implement the KID.
KIDs are to be produced with information as of 31 December each year and it is likely that they will need to be produced in most cases for each share class. They have to be translated into the languages of the countries in which the share class is distributed. The Committee of European Securities Regulators (CESR) recommends a deadline of 35 calendar days for updating the KID information and handling of material changes. The production of the KID, as well as the monitoring of material changes that will require a new KID to be produced, will require the implementation of new controls and processes.

For instance a fund house with a range of 50 funds with five share classes each, that distributes all funds in five countries will need to produce at a minimum 1,250 KIDs each year. Should material changes occur such as to charges or to the SRRI, it may be that this number jumps to 2,500 to 3,750 KIDs per year. This will have cost implications for asset managers and funds.

Cost implications

However, 58% of respondents have not considered the cost implications of changes to their systems and controls to implement the KID.

Those that have considered the cost implications think that “the production of the KID will be a significant resource drain”. This is seen as a disadvantage, especially for fund houses with a large institutional investor base, as it is unlikely that institutional clients will be relying on the KID to make investment decisions.

Training of distribution staff

73% of respondents believe that there will be a need to train distribution staff on how to read and use the KID. However, the view is held that “the document will not be very complicated to understand by distribution staff, hence that training will not be difficult”.

Where a fund house uses third parties for distribution (e.g. banks, IFAs or networks), only 38% think they need to train third parties how to read and use the KID. This is due to the view being held that the KID will be a standardised paper and therefore third party distributors “should already be familiar with the document”.

Concluding thoughts

It is surprising that less than 40% of the respondents have considered the cost implications of preparing the KID. For fund houses that produce financial information in-house, the production of the KID with result in pressure on resources in January and February, historically already a time of resource constraint. Also, they will be looking to develop an automated solution as the volume of KIDs required (generally one per share class), makes manual production impossible.

For those that have outsourced the production of financial and performance data, they will need to review existing services level agreements and work with their third party providers to come up with a workable solution.

In any case, the production of the KID will require careful planning, and will have resource and cost implications that should be assessed and reviewed as soon as possible to ensure asset managers are ready to meet the requirements.
Investment management companies have identified many KID requirements that they believe are challenging.

As a final question in the survey, respondents were asked to highlight the most challenging KID rule to observe from the perspective of an asset management company. The following reflects the results in relation to the choices provided.

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<tr>
<th>Requirement</th>
<th>Percentage of respondents</th>
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<tr>
<td>The number of KIDs</td>
<td>24%</td>
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<tr>
<td>Monitoring the risk indicator, and inherent updating of the KID</td>
<td>24%</td>
</tr>
<tr>
<td>The risk indicator methodology</td>
<td>19%</td>
</tr>
<tr>
<td>Disclosing the funds’ investment policy in “non-technical language”</td>
<td>16%</td>
</tr>
<tr>
<td>The requirement of the yearly update of the KID within 35 calendar days as from 31 December</td>
<td>14%</td>
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There is a wide spread of results, suggesting that respondents see numerous challenging aspects regarding the production of the KID. Respondents also commented that they would have liked to have highlighted several boxes, meaning that several of the above are regarded as equally challenging.

Concluding thoughts

These questions have highlighted that fund houses are concerned about a large number of different requirements relating to the production of the KID.

This is consistent with the remainder of the survey. Respondents still have not considered all of the requirements, and those that have are identifying potential issues such as availability of resources and cost implications.

Fund houses should also assess when they need to start producing the KID. Even though this part of the Directive has been grandfathered until 1 July 2012, the questions remains whether funds and/or sub funds being launched post 1 July 2011 require a KID – if they do, fund houses and asset serving firms need to be operationally prepared for the KID by June 2011.

In order to avoid being caught out by the KID, it is essential that fund houses start assessing the rules and requirements and the implications they have on their processes and controls now.
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