

PACKAGED RETAIL INVESTMENT PRODUCTS

Investor Disclosure Considerations
for a Key Information Document



CFA Institute



PACKAGED RETAIL INVESTMENT PRODUCTS

Investor Disclosure Considerations
for a Key Information Document

©2013 CFA Institute

CFA Institute is the global association of investment professionals that sets the standard for professional excellence. We are a champion for ethical behavior in investment markets and a respected source of knowledge in the global financial community.

Our mission is to lead the investment profession globally by promoting the highest standards of ethics, education, and professional excellence for the ultimate benefit of society.

978-0-938367-78-9
September 2013

Contents

Executive Summary	1
1. Introduction: Meaningful Comparison through a Standardised Framework	6
2. Scope and Methodology	9
3. The Retail Investment Products Market	11
4. Why Costs Matter	16
5. Retail Investment Funds	19
6. Insurance Products with an Investment Component	26
7. Structured Products	35
8. Conclusions on Costs	45
9. Other Considerations for the PRIPs KID	48
10. Summary Policy Considerations	51
Appendix A. UCITS KIID	54
Appendix B. KIID for Complex Financial Products (Portugal)	56
Appendix C. Structured Product Payoffs (Illustration)	57
Appendix D. Product Information Sheet (Germany)	59
Bibliography	62

Executive Summary

Packaged

retail investment products (PRIPs) are products that contain an element of packaging or wrapping that is applied to an underlying investment opportunity, including shares, bonds, and other assets. These products enable retail investors to gain exposure to securities markets and financial instruments that might otherwise be prohibitively difficult or inefficient to access. Accordingly, PRIPs enable retail investors to allocate their savings in a more efficient manner.

However, concerns have been raised by investment professionals about the sale of investment products. In the CFA Institute¹ 2013 Global Market Sentiment Survey, members in Europe, the Middle East, and Africa (EMEA) most frequently identified mis-selling of products by financial advisers as their top ethical concern. The problem

¹CFA Institute is the global association of investment professionals that sets the standard for professional excellence and credentials. The organization is a champion for ethical behaviour in investment markets and a respected source of knowledge in the global financial community. The end goal is to create an environment where investors' interests come first, markets function at their best, and economies grow. CFA Institute has more than 117,000 members in 139 countries and territories, including almost 110,000 Chartered Financial Analyst® charterholders, and 138 member societies. CFA Institute promotes fair, open, and transparent capital markets and advocates for investors' protection.

of mis-selling is exacerbated by poor disclosures. Currently, the disclosures provided to investors in PRIPs are often complex, lengthy, and incomparable; moreover, disclosure practices and regulations are divergent within the European Union (EU). Consequently, product transparency is deficient.

Legislative proposals to address disclosure practices are under development at the EU level through draft regulation on PRIPs. The draft regulation proposes a key information document (KID) to provide concise and standardised information on the key characteristics of different retail investment products to facilitate consumer comprehension and comparability.

A particular challenge of the KID proposals is to determine the relevant fees and costs to be disclosed for different types of PRIPs. Costs are a key determinant of the net return an investor will receive on his or her investment. Among many retail investors, however, the effect of costs on investment returns is not well understood. Consequently, fees and costs are often overlooked or are not given sufficient weight in the investment decision-making process.

Transparency over costs is essential to facilitate the purchase of suitable products by investors and to achieve an efficient allocation of savings.

In this report, the various fees and costs associated with the most common types of PRIIPs are examined, including retail investment funds, insurance products with an investment component, and structured products. Policy considerations are addressed on the basis of the findings.

The objective of this report is to inform the EU policy debate and regulatory developments related to the KID for PRIIPs from the perspective of investors, with the ultimate goal of improving transparency and investors' protection.

Summary of Findings

Investment Funds

- In the EU, the majority of funds sold to retail investors are qualified as Undertakings for Collective Investment in Transferable Securities (UCITS). Recent UCITS legislation regulates the provision and disclosure of key investor information through the UCITS KIID (key investor information document), applicable since July 2012. Under the charges section of the KIID, the following costs must be presented:
 - ▲ Entry and exit charges
 - ▲ Ongoing charges
 - ▲ Performance fee (if applicable)

Insurance Products with an Investment Component

- Currently, there is no single pre-contractual information document in the EU that summarises key information on insurance products. Various national initiatives have been developed that provide for different types of product disclosures. Examples include Belgium's financial info sheet, the Netherlands' financial information leaflet, the United Kingdom's key features document or illustration (which includes a tabular presentation of the effect of charges over certain time horizons), and Portugal's KIID for complex financial products (including life insurance products).

Structured Products

- The costs and charges associated with structured products are typically embedded in the price of the product and derive from the combination of assets used to structure the issue, particularly the derivatives held within the structure. Because the pricing of

these instruments is complex, it is difficult for retail investors to ascertain the specific cost components or to compare costs among products. National rules and disclosures regarding pre-contractual information on structured products vary widely.

Summary Policy Considerations

Based on the findings and conclusions in this report, we recommend the following policy considerations for the development of the PRIPs KID.

Scope

1. The initial scope of the PRIPs regime should be packaged products that provide for exposure to the performance of an underlying investment portfolio or other assets. Ultimately, the packaging provides the conduit for the investment exposure, and it is this packaging that determines the primary costs and other key features of the product. If, after review, the initial PRIPs KID is successful with consumers, the scope could be extended beyond packaged products.

Format

2. The PRIPs KID could use the UCITS KIID (given its recent introduction) as the baseline for developing the content of disclosures. The UCITS KIID disclosures could be tested against different types of PRIPs to determine how well the disclosures fit the product concerned. Appropriate amendments could then be made to the disclosure content based on product testing.
3. To allow flexibility, consideration should be given to setting a maximum length for the KID document, rather than a fixed number of pages. This approach would allow those products that require additional detail to be adequately disclosed, rather than left out or reduced to insufficient disclosures. The number of pages should, of course, be few (for example, a maximum of three pages) to maintain a concise presentation.

Costs

4. Costs should be disclosed under a standard label and location in the KID, but the content of cost disclosures could embody a small degree of flexibility beyond common components. Common components could include
 - ▲ entry fees (including any subscription, acquisition, or initial transaction fees);

- ▲ exit fees (including any redemption, reimbursement, or sale fees);
 - ▲ ongoing charges;
 - ▲ performance fees;
 - ▲ transfer fees, buying or selling charges, and any penalties, if applicable; and
 - ▲ any other administrative charges.
5. Cost disclosures should include a statement specifying the total amount in percentage terms that the product manufacturer or sponsor receives from distribution arrangements (inducements), if any.
 6. For life insurance products, a tabular presentation that illustrates the effect of costs in standardised monetary terms over predefined time horizons should also be provided. Given space constraints in the PRIPs KID, at a minimum, this type of disclosure should be signposted to a website containing the relevant information.
 7. Cost disclosures for structured products should include a narrative explanation of the total costs included in the amount paid for the product. For example, a sentence might explain that the issuance price includes an issuer concession or markup of $x\%$, or that the amount invested in the underlying assets or instruments is reduced by an equivalent amount of the explicit cost.
 8. Structured product disclosures should include standardised numeric details of any fees and costs associated with buying or selling the security during the life of the product, as well as any early redemption or termination charges.

Risks

9. The risk of the product, as reflected by the summary risk indicator, should incorporate its volatility. If volatility calculations (such as the standard deviation of returns) are not possible, either owing to the type of product or a lack of historical data, the KID should at least provide for adequate narrative disclosures of risk. Such disclosures should include an explanation of the risk associated with the product's benchmark or the index or asset(s) it references or is linked to.
10. In the case of products with set maturities and predefined payoffs (such as structured products), risk should be measured with regard to the variability or range of possible outcomes at maturity, with appropriate disclosure of how this risk may vary during the life of the product (and hence, the risk associated with early redemption or exit from the product).

11. Narrative disclosures should also include (among other things) details of significant risks arising from the investment strategy of the product, details of any national financial compensation scheme protecting investors in the event of default or failure of the product manufacturer, and details of the creditworthiness of the issuer where appropriate.

Performance

12. Past performance data should be presented in an analogous manner to the UCITS KIID—namely, in the form of a bar chart that shows yearly net performance in percentage terms alongside relevant narrative disclosures. These narrative disclosures should include (but would not be limited to) the basis of the return calculation, such as the measurement period; the treatment of any income arising over the period; and the fees and costs that the return is net of. Specifically, return data should take into account ongoing charges and transaction costs.
13. Past performance information should be limited to those products that have sufficient actual performance history. Proxy performance data, or simulated performance data, should not be used instead of, or linked to, actual performance history.
14. For structured or guaranteed products and funds, a tabular presentation of performance scenarios would be appropriate in place of past performance data (located under a different section of the KID). To facilitate comparability, the number and type of scenarios for structured funds and products should be prescriptive and uniform in the KID.

1. Introduction: Meaningful Comparison through a Standardised Framework

Packaged retail investment products (PRIPs)—savings or investment products manufactured for the retail market, typically via the application of packaging or wrapping to an underlying investment opportunity—serve a key role in facilitating individual wealth accumulation. They provide a mechanism that enables retail investors to gain exposure to securities markets and financial instruments that might otherwise be prohibitively difficult or inefficient to access. In doing so, such products provide retail investors with a more varied and efficient set of possibilities to meet their specific financial needs.

However, the way in which these products are sold, including product distribution and product disclosures, can greatly affect the ability of retail investors to realise their investment goals.

Concerns about the sale of investment products have been raised by investment professionals. In a 2009 retail investment products survey of CFA Institute members² based in the European Union (EU), 64% responded that the fee structures of investment products were driving sales to customers rather than product suitability.³ Furthermore, in CFA Institute's 2013 Global Market Sentiment Survey, when asked to rank—from most serious to least serious—six ethical issues facing their local markets, members in Europe, the Middle East, and Africa (EMEA) most frequently identified mis-selling of products by financial advisers as the most serious concern.⁴ In the same survey in 2012, mis-selling was ranked as the most serious ethical issue both in EMEA and globally.

²The membership of CFA Institute comprises more than 117,000 portfolio managers, investment analysts, and other investment professionals in 139 countries and territories, including almost 110,000 Chartered Financial Analyst® charterholders.

³The survey is available at www.cfainstitute.org/Survey/retail_investment_products_poll.pdf.

⁴The survey is available at www.cfainstitute.org/Survey/global_market_sentiment_survey_2013.pdf. Among European countries, product mis-selling was identified as the most serious ethical issue in Spain, France, Germany, Switzerland, Austria, the United Kingdom, the Netherlands, and Italy.

Sales practices in the EU are varied and suboptimal with respect to both distribution structures and product disclosures. In the case of distribution, the fee structures, incentives, and ownership of distributors may create conflicts with clients' best interests. These conflicts can result in products being sold that are not well suited to an individual's specific return objective and risk tolerance.

Moreover, the disclosures that retail investors are provided with concerning the characteristics of different products are often complex, lengthy, difficult to understand, and incomparable. In many cases, product disclosures are mired in legalese with little apparent regard for consumer comprehension of the economic substance of the product. Such opacity can hamper the ability of retail investors to make well-informed decisions, resulting in the purchase of unsuitable products or a bias toward placing savings in simpler products, such as bank accounts. Either way, poor disclosures may lead retail investors to invest inefficiently.

Legislative proposals to address disclosure practices are under development at the EU level.⁵ In July 2012, the European Commission published a draft proposal for a regulation covering PRIPs.⁶ This draft regulation, currently under political negotiation, aims to improve transparency for retail investors through the introduction of a key information document (KID) for PRIPs.

The purpose of the KID is to provide focused, standardised, and comparable information on the key characteristics of different retail investment products to enable consumers to make more informed investment decisions. The KID builds off the key investor information document (KIID) for UCITS (Undertakings for Collective Investment in Transferable Securities), which are the predominant type of investment funds sold to retail investors in the EU. The UCITS KIID, which went into effect in 2012, provides concise information about the essential characteristics of a UCITS fund in only a two-page document. Extending this type of disclosure framework to all retail investment products is thus an appropriate starting point to create a level playing field among all types of retail investment products.

The PRIPs KID should include information on the objective, return, risks, and costs of the product in question, and it should be as standardised as possible to allow comparison among products. But given the number and diversity of retail investment products, developing a standardised framework that allows for meaningful comparison is challenging.

⁵Practices associated with the distribution of products are addressed through separate pieces of legislation, including the Insurance Mediation Directive (IMD) and the Markets in Financial Instruments Directive (MiFID).

⁶The legislative proposals take the form of a Level 1 regulation (framework principles that must be applied directly across EU member states). The regulation will be supported by subsequent legislation at Level 2 (detailed implementing measures).

A particular challenge is to determine the relevant fees and costs to be disclosed for different types of PRIPs and the type of disclosures to be made in the KID. Costs are a key determinant of the net return an investor will receive on his or her investment. Moreover, costs are frequently the least transparent aspect of pre-sale contractual disclosures. As such, retail investors have difficulty understanding the effect of costs on investment returns and, hence, typically pay insufficient attention to this aspect of investing.

A complete presentation of fees and costs in a manner that is easy to understand is thus a necessary (if not sufficient) component of the information set needed by retail investors to support informed investment decisions.

To further the aims of improving product transparency in the area of costs, the various fees and costs associated with the most common types of PRIPs, including retail investment funds, insurance products with an investment component, and structured products, are examined in this report. We offer policy considerations on the basis of our findings.

The primary objective of this report is to inform the EU policy debate and regulatory developments related to the KID for PRIPs. However, these disclosure issues also have global relevance and hence may inform future policy discussions in non-EU jurisdictions.

2. Scope and Methodology

2.1. Scope

The scope of the proposed PRIIPs regulation generally includes all products sold to retail investors for which the return on the product is exposed to the performance of one or more assets or reference values. Specifically, the following products are included within the scope of the proposed PRIIPs regulation:

- Investment funds, whether closed-end or open-end, including UCITS;
- Insurance products with surrender values that are linked to the returns on investments (including derivatives) made by insurance companies—that is, any insurance product with an investment component;
- Retail structured products (including products with capital guarantees and products for which a proportion of the return is also guaranteed); and
- Investment products with the purpose of accumulating savings for individual pensions.

Certain occupational pension schemes, including schemes in which the employer is mandated by national law to make contributions and in which the employee has no choice over the pension product provider, are currently out of scope. Investment funds sold to institutional investors are also out of scope.

The European Commission's proposed regulation also excludes direct holdings of equity shares and bonds, as well as bank deposits (that is, deposits related to an interest rate). These products may not be considered packaged or structured. However, the European Parliament's draft report of December 2012 on PRIIPs proposed to widen the scope of the regulation to include direct holdings of shares, bonds, and bank deposits. Consequently, the final scope of the PRIIPs regulation is unclear at the time of this writing.

In lieu of these considerations, the scope of this report includes the core products unambiguously within the scope of the PRIIPs regulation:

1. Retail investment funds

2. Insurance products with an investment component
3. Structured products

These products also carry a degree of complexity owing to their packaging, in contrast to plain vanilla investments, such as direct holdings of equity shares or bank deposits. A focus on these three types of products is, therefore, likely to be of most value to investors and policymakers.

2.2. Methodology

For each of the three classes of products within scope, we analyse the main product characteristics and detail the key cost components. We then examine the form and content of existing disclosures of costs, drawing from examples among EU member states. On the basis of this analysis, we offer policy considerations regarding the types of cost disclosures that should be included within a KID for PRIPs. Finally, other disclosure considerations are addressed.

3. The Retail Investment Products Market

This section outlines the basic structure of the market for PRIPs, including the primary market participants, and presents data on the relative holdings of PRIPs at the European and national level for a selection of key markets.

3.1. Structure

The firms supplying investment products to retail customers can be generally classified into two groups: (1) manufacturers and (2) distributors.

Manufacturers comprise those firms that create the investment product, such as asset managers, insurance companies, pension fund managers, and banks. These entities manufacture the investment package and may manage or maintain client money held within the product.

Distributors facilitate the sale of investment products to retail customers and thereby link manufacturers with consumers. Some larger product manufacturers have direct distribution capabilities through in-house sales teams. But the majority of product sales take place through banks or bancassurance entities, or through third parties, such as financial advisers or intermediaries. A fourth distribution channel is fund supermarkets and online platforms.

Bancassurers are banks operating in partnership with an insurance firm. Insurance and other investment products are sold through the bank's retail branch network. Bancassurers may be tied to one or more manufacturers (that is, only sell products manufactured by a subsidiary or related insurance entity) or offer a full range of market products. Bancassurance is the predominant distribution channel for PRIPs sold in France; in Germany, banks are the predominant distribution channel.

Financial advisers and intermediaries include independent financial advisers (IFAs) and tied agents. IFAs provide access to the whole range of market products and are not tied to a particular manufacturer or manufacturers. Tied agents, however, only advise on or sell products that are affiliated with one or more manufacturers. Financial advisers or intermediaries

may also be part of a network that provides the necessary infrastructure to support the adviser's business. IFAs are the predominant distribution channel for PRIPs sold in the United Kingdom.

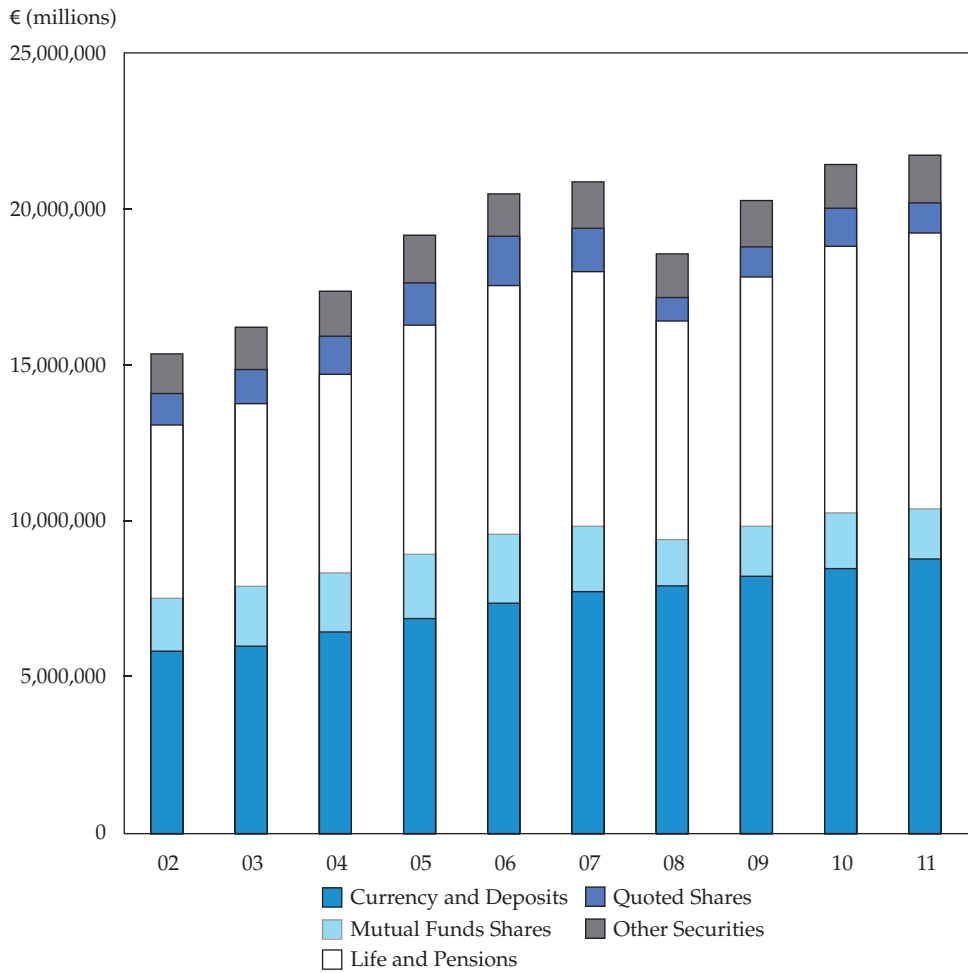
3.2. Summary Data

Data on the size and relative proportions of household assets invested in the main classes of PRIPs are presented in the following figures. Specifically, household assets in investment funds (mutual funds, such as UCITS), life insurance and pensions, currency and deposits, quoted shares, and other securities excluding shares and derivatives, are illustrated. Specific and comparable data on structured products are not readily available.

Figure 1 shows household assets in the aforementioned investment categories for the European Union (aggregate data for 27 member states), measured in millions of euros. Despite a downturn in 2008 associated with the financial crisis, household financial assets have trended upward over the 10-year period shown. The relative proportions of these assets, shown in **Figure 2**, have remained steady. Life insurance and pensions together with investment funds comprise almost half of EU household financial assets (averaging 48% over the period shown). Holdings of currency and deposits average 39%, whereas security holdings (quoted shares and other securities) average 13% of assets.

Among EU member states, relative holdings in retail investment products differ. **Figure 3** illustrates the relative proportions of household financial assets for the four largest EU member states—Germany, France, Italy, and the United Kingdom. The proportion of holdings in life insurance and pension funds is highest in the United Kingdom at 48%. Italy has the largest proportion of holdings in other securities excluding shares and derivatives (27%), which most likely reflects Italy's large domestic bond market and relatively high levels of retail investment in bonds. The proportions of assets are similar in France and Germany. Life insurance and pension fund holdings amount to 35% in Germany and 41% in France, whereas currency and deposits account for approximately 40% of financial assets in each country.

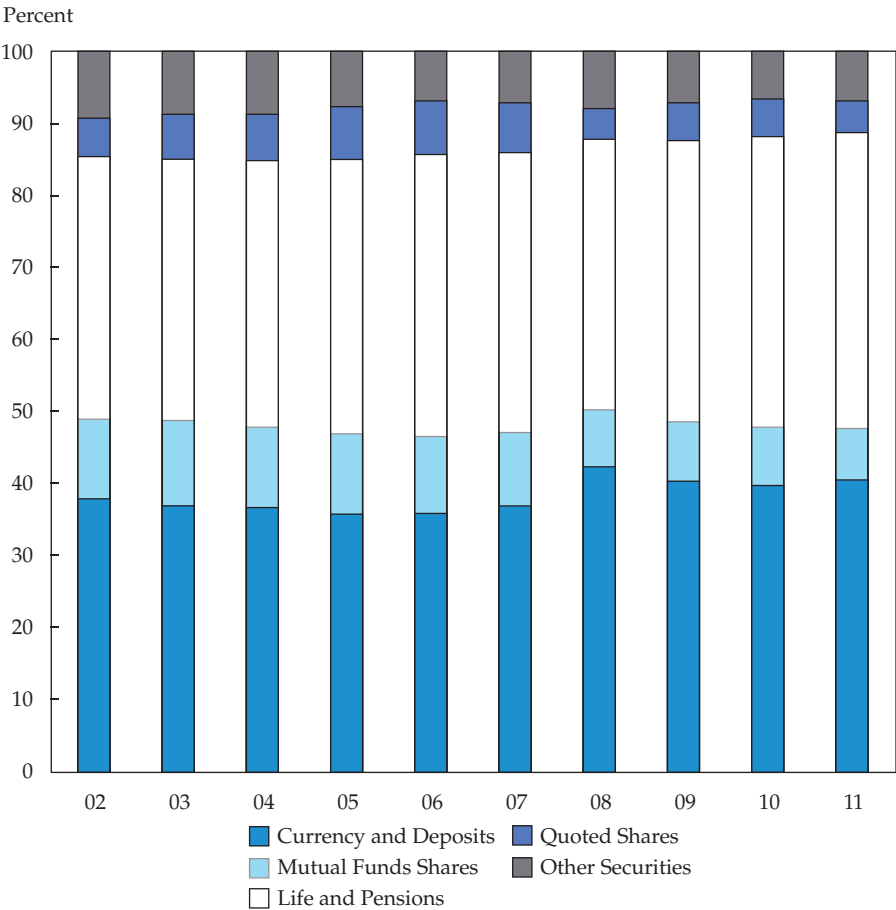
Figure 1. EU Households' Financial Assets



Notes: The category Life and Pensions is the net equity of households in life insurance reserves and pension fund reserves. Other Securities includes securities other than shares or financial derivatives.

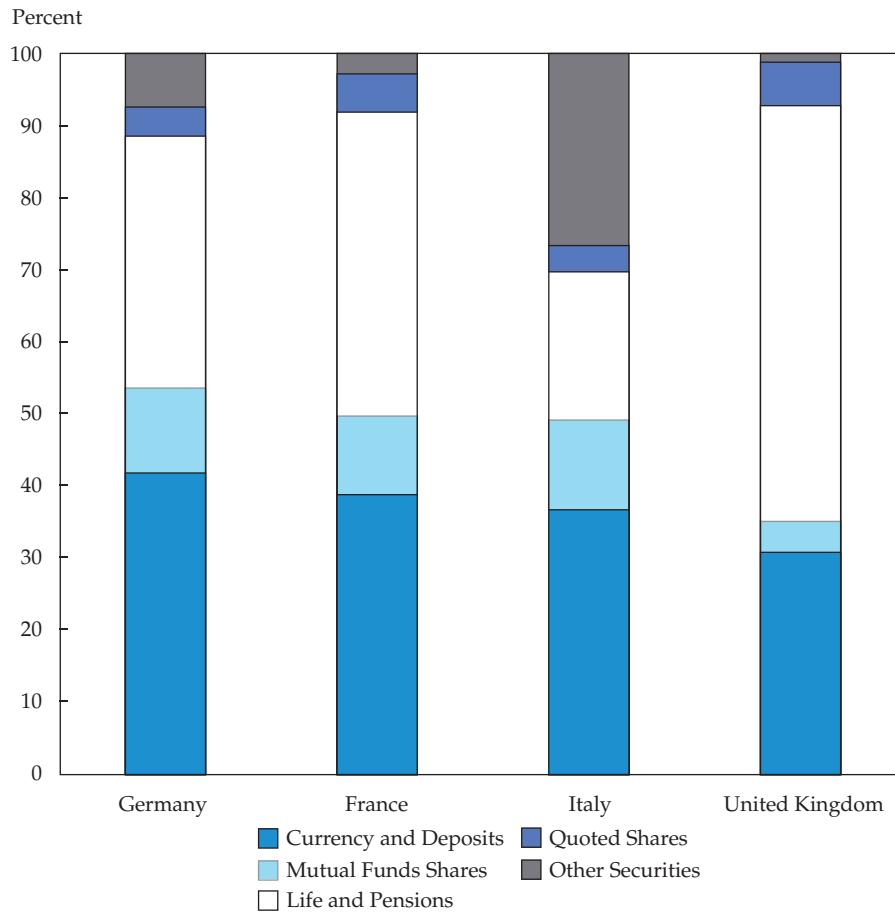
Source: Based on data from Eurostat.

Figure 2. EU Households' Proportions of Financial Assets



Source: Based on data from Eurostat.

Figure 3. Households' Average Proportion of Financial Assets by Country, 2002-2011



Source: Based on data from Eurostat.

4. Why Costs Matter

Among many retail investors, the impact of costs on investment returns is not well understood. Consequently, fees and costs are often overlooked or are not given sufficient weight in the investment decision-making process. Inadequate attention to costs can result in sub-optimal investment decisions or the selection of unsuitable products.

The importance of costs lies in the effect of compounding. Over long time horizons, fees, expenses, and other costs can significantly diminish returns as wealth is transferred from investors to intermediaries.

This effect is illustrated in the following example. Assume an initial investment of €1,000 at the start of Year 1 in a product yielding a gross return of 8% per annum with total costs of 2% per annum. The value of the investment over a 60-year period is illustrated in **Figure 4**.

The dashed line in Figure 4 shows the value of the investment in the absence of any costs—that is, growth of 8% per annum. The solid line shows the value of the investment after the deduction of costs—that is, the wealth accumulating to the investor based on the net return of 6% per annum. The divergence of the two lines is exponential, reflecting the compounding effect of costs. In other words, as a result of paying 2% costs per annum, the investor earns 2% less on his or her investment each year, a loss that is compounded each year.

What is striking is that by the end of the 60-year period, the investment is worth €32,988—fully €68,269 less than it would have been in the absence of costs.

Modifying the cost assumption, however, has a significant effect. For example, suppose costs are reduced by only 0.5 percentage points but all other assumptions remain unchanged. The value of the investment over the 60-year horizon is depicted in **Figure 5**.

Under this second scenario, the investor's accumulated wealth at the end of 60 years is €43,750, which represents an increase of €10,762 on the previous example. In other words, a reduction in costs of 0.5 percentage points per annum increases the investor's return by 33% over the period—a significant gain.

These examples demonstrate the vital importance of costs in determining the generation of wealth for investors. Moreover, these illustrations emphasize that even apparently small differences in costs can have a sizeable impact on returns over long time horizons.

Figure 4. Impact of Costs on Investment Returns (Illustration): 2% Annual Costs

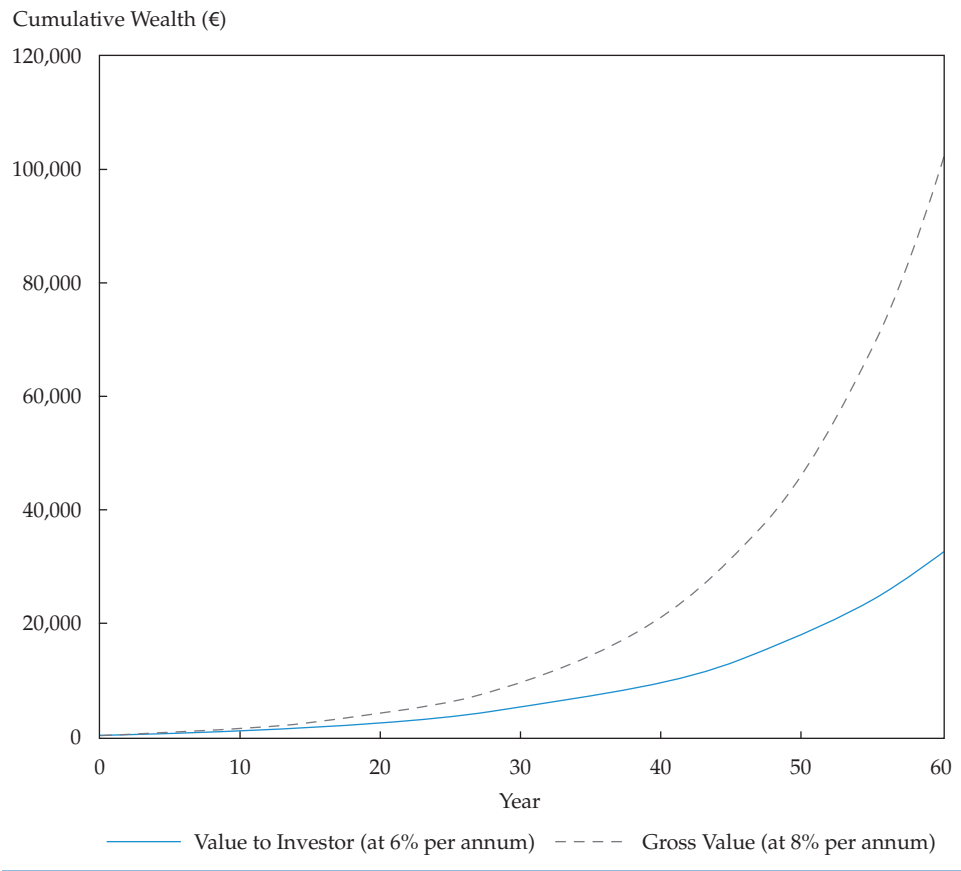
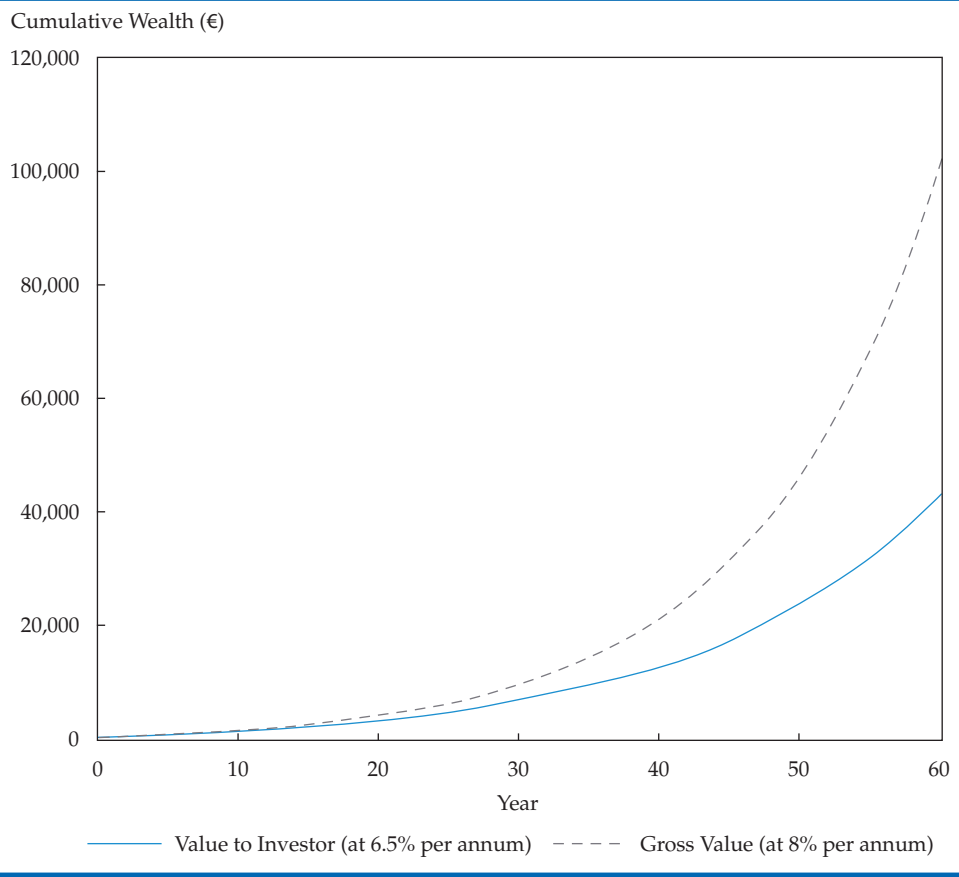


Figure 5. Impact of Costs on Investment Returns (Illustration): 1.5% Annual Costs



5. Retail Investment Funds

The fees, charges, and other expenses most commonly borne by retail investment funds are outlined in Section 5.1. In Section 5.2, existing cost disclosures associated with retail investment funds are analysed, with a focus on the disclosures provided under the KIID for UCITS.

Funds sold to retail investors include open-end and closed-end funds. Open-end funds do not have a fixed number of shares or units in issue; shares or units are created or cancelled when investors buy into or sell out of the fund. Open-end funds most commonly include, but are not limited to, UCITS structures, such as unit trusts and open-ended investment companies (OEICs), also known as investment companies with variable capital (ICVC or SICAV). The price of units or shares in these funds is determined mechanically and equates to the net asset value (NAV) of the fund divided by the number of units or shares.

Closed-end funds have a fixed number of units or shares in issue and are listed and traded on exchanges. Examples include exchange-traded funds (ETFs), which can also be manufactured and marketed under the UCITS framework, and investment trusts. The price of units or shares in these types of funds is market driven, but arbitrage ensures that the market price of the fund does not deviate far from the NAV.

Investment funds, whether open- or closed-end, provide retail investors with efficient access or exposure to a portfolio of underlying securities or financial instruments. Such pooled investment schemes allow retail investors to realise economies of scale.

5.1. Costs

The most common types of costs incurred by retail investors in investment funds include entry and exit charges, ongoing charges, transaction costs, and other costs.

(a) Entry and Exit Charges

These costs, if applied, are typically charged as a percentage of the value being invested or redeemed. Entry and exit charges may be discounted in part or in whole depending on the product wrapper or the distribution channel. For example, financial advisers and other intermediaries may negotiate discounts on the initial charge with the product manufacturer,

or the manufacturer may simply waive entry charges for certain wrappers. Exit charges, if applied, typically decline the longer the investment is held. For example, many products do not apply exit charges from holdings greater than five years.

(b) Ongoing Charges

These costs relate to the management, administration, and operating expenses of the fund and typically include the following charges.

- *Annual management charge (AMC).* The AMC is the fee paid from the fund to the management company for managing the investment portfolio (strategic and tactical asset allocation and stewardship of client assets). The AMC represents the cost for the service of portfolio management. It most commonly represents a percentage charge based on the NAV of the fund, although a fixed monetary amount is also possible. The AMC is typically less than 2% of the NAV and accounts for the majority of the fund's total expenses (for example, the AMC can often be more than four-fifths of ongoing expenses).
- *Depository fees.* The depository of the fund is responsible for the safekeeping of the fund's assets (a function that may be delegated to a separate custodian) and for collecting any income arising from those assets. The depository is also responsible for ensuring that the pricing and dealing in the fund's units or shares are carried out in accordance with applicable rules or laws. Depository fees are typically calculated according to a percentage (or tiered percentages) of the fund's NAV.
- *Custodian fees.* These fees relate to the custody or safekeeping of assets held within the investment portfolio. Custodian fees are typically charged as a percentage of the value of investments.
- *Registration fees.* These fees are charged to the fund for maintaining the unit or share registry. They are typically charged as a monetary amount per unit or share in issue.
- *Regulatory fees.* Authorised funds may be required to pay a fee to the relevant competent authority. Any fee charged is partly a function of the extent to which the competent authority is funded by the industry and/or whether a consumer compensation scheme or redress mechanism exists in the jurisdiction concerned. Regulatory fees are typically charged at a fixed monetary amount.
- *Audit fees.* Authorised investment funds, such as UCITS, are required to prepare periodic reports and financial statements and to have the annual report and financial statements audited by a third party. Audit fees are charged at a set monetary amount.

- *Professional service fees.* These costs include tax, legal, advisory, and other fees incurred for the provision of any third-party professional services to the fund.
- *Administration and other fees.* These fees, if applied, relate to any other expenses for the ongoing administration of the fund.

(c) Transaction Costs

Transaction costs are incurred for executing portfolio purchases and sales. The extent to which a fund incurs transaction costs is partly a function of whether the fund pursues a passive or an active investment approach. In the case of passive investment, such as index tracker funds, transaction charges arise largely as a result of investor subscriptions and redemptions (the need to invest or divest client money) or because of the need to rebalance the portfolio periodically to keep asset weightings in line with the index or benchmark being tracked.

For actively managed funds, transaction costs are incurred largely as a result of tactical asset allocation decisions. In other words, transaction costs arise from the manager actively buying and selling securities (turning over the portfolio) beyond the need to invest or divest fund inflows or outflows. Active fund managers make purchases and sales in the belief that such transactions will increase the fund's returns over and above the costs incurred from trading.

Transaction costs can be classified as follows:

- *Direct transaction costs.* These are costs borne explicitly by the fund and include the direct costs of trading, such as brokerage commissions and taxes.
- *Indirect transaction costs.* These are implicit transaction costs that are embedded in the dealing price—namely, the bid–offer spread (incurred when the manager uses market orders to execute trades, buying securities at the offer price and selling at the bid price). Indirect transaction costs may also include market impact, which reflects the cost of adverse price movements upon revelation of the order in the market (the extent to which the order moves the market price away from the manager). Market impact is also measured in terms of slippage or implementation shortfall, which accounts for the difference between the decision price and realised execution price.

Additionally, when investor subscriptions or redemptions result in portfolio transactions being made that may adversely affect continuing unit/shareholders (such as particularly large purchases or sales that cause market impact), a dilution adjustment or levy may be

applied. This dilution adjustment may take the form of an explicit levy or an implicit adjustment to the dealing price (for example, swinging the mid-price of the fund to either the bid or offer) so that the investors buying into or selling out of the fund bear the adverse transaction costs, not the remaining investors.

(d) Other Costs

Other expenses that are neither ongoing annual charges nor transaction costs include the following fees:

- *Performance fees.* These fees, if applied, are paid from the fund to the manager for exceeding certain performance targets. Performance fee mechanisms include hurdle rates (the rate of return a manager must beat before receiving performance fees) and high-water marks (the high price or NAV that must be exceeded). Performance fees are common among hedge funds and are not typically applied in retail funds.
- *Stock lending fees.* Managers can generate income for their funds by lending securities held in the fund's portfolio to other entities. Securities are loaned in exchange for a payment (income to the fund). The fund management company may utilise a lending agent that serves as an intermediary between the fund (the lender) and the borrower. Part of the income received by the fund for lending securities may be shared with the management company. Additionally, a fee may be paid back to the lending agent, which further subtracts from the income available to the fund. Disclosures vary; typically, the net income from stock lending is disclosed in financial statements, and sometimes the split of income shared with the management company and/or lending agent may be included in narrative disclosures to the financial statements.
- *Interest charges.* These costs relate to any borrowings or bank overdraft facilities applicable to a fund. Because most funds are close to fully invested, interest costs are infrequent rather than ongoing.
- *Payments associated with holdings in financial derivatives.* These include costs associated with any margin calls or payments related to the servicing of derivatives positions.
- *Funds-of-funds fees.* Investment funds that invest in other investment funds indirectly bear the costs associated with the underlying funds. However, to avoid double-charging, funds of funds commonly receive fee rebates from the underlying funds or reductions to the AMC to equalise the net expense.

5.2. Existing Disclosures

In the EU, the majority of funds sold to retail investors are qualified as UCITS. Recent UCITS legislation regulates the provision and disclosure of key investor information through the KIID.⁷ In most jurisdictions, the KIID replaces the simplified prospectus. The purpose of the KIID is to provide investors with clear, concise, and relevant information about the essential characteristics of the UCITS in a two-page document. Under the legislation, all UCITS funds had to have a published KIID by 1 July 2012 that includes the following components:

1. Identification of the UCITS
2. Objectives and investment policy
3. Risk and reward profile
4. Charges
5. Past performance
6. Practical information

These disclosures are illustrated in **Appendix A**, which shows the KIID template publicised by the Committee of European Securities Regulators (CESR).⁸

Specifically, under the charges section of the KIID, the following costs must be presented:

- Entry and exit charges
- Ongoing charges
- Performance fee (if applicable)

Entry and exit charges and ongoing charges include the costs outlined in Subsections (a) and (b), respectively, of Section 5.1. Transaction costs in Subsection (c), however, are not included in the KIID charges disclosures.

⁷The relevant legislation is Commission Regulation 583/2010 implementing Directive 2009/65/EC of the European Parliament and the Council.

⁸CESR was replaced by the European Securities and Markets Authority (ESMA) effective 1 January 2011.

CESR issued guidelines on the methodology for the calculation of the ongoing charges figure included in the KIID. The guidelines define ongoing charges as “all annual charges and other payments taken from the assets of the UCITS” and specify that the “ongoing charges figure shall be the ratio of the total discloseable costs to the average net assets of the UCITS. . . . The figure shall be expressed as a percentage to two decimal places” (CESR 2010a).

Prior to the KIID, UCITS were requested to provide information to investors on the total expense ratio (TER) of the fund. The TER may still be reported in other fund literature, such as annual reports.

The TER is the ratio of the fund’s total operating expenses to its average net assets over the relevant reporting period. Specifically, total operating expenses include (1) management costs; (2) administration costs; (3) fees linked to depositary duties; (4) audit fees; (5) payments to shareholder services providers; (6) payments to broker/dealers that are record owners of the fund’s shares and that provide sub-accounting services; (7) payments to lawyers; (8) any distribution or unit cancellation costs charged; (9) registration fees, regulatory fees, and similar charges; (10) any additional remuneration of the management company (or any other party) corresponding to certain fee-sharing agreements; and (11) performance fees. The total operating costs do not include entry/exit commissions, transaction costs, interest on borrowing, payments incurred in relation to derivatives, or soft commissions.

The main difference between the TER and the ongoing charges figure is that the TER includes performance fees whereas the ongoing charges figure does not (performance fees are disclosed separately in the KIID). Otherwise, the two measures are comparable.

For funds that publish financial reports, either by regulatory statute or otherwise, fund operating costs or ongoing charges are typically itemised within the expenses note to the financial statements, thus providing investors with further detail on these costs and their monetary amounts. These financial reports also typically disclose the percentage charges for the AMC and the TER or ongoing charges figure.

Costs Not Disclosed in the KIID

As noted earlier, transaction costs are not disclosed among charges in the KIID. But when the impact of transaction costs is likely to be material due to the strategy adopted by the fund, the regulations require a statement acknowledging this likelihood in the “objectives and investment policy” section of the KIID. But details of these transaction costs, such as their type and magnitude, are not disclosed.

In some EU member states, such as the United Kingdom, such direct transaction costs as brokerage commissions and taxes are required to be disclosed in the fund's annual report and financial statements. U.K. authorised funds, for example, set out the monetary amount of brokerage commissions and taxes as additions to the cost of portfolio purchases or deductions from portfolio sales proceeds in a note to the financial statements. Indirect costs, however, are not disclosed; rather, they are embedded in the investment gains or losses accruing to the fund. They may also be reflected in the dealing price of the fund's units/shares depending on the fund's pricing structure.

One line of reasoning espoused by those arguing against the inclusion of direct transaction costs within the charges section of the KIID is that ongoing charges, such as management fees, are usually reasonably stable, whereas brokerage costs are not. Transaction costs are determined by the level of trading undertaken by investment managers and hence vary according to changing market conditions and the level of subscriptions and redemptions, which are outside of the fund manager's control. The level of transaction costs can, therefore, vary significantly from one year to the next. Additionally, because transaction costs also vary from one investment strategy to another, some argue that they are not comparable from one fund to another.

Reporting indirect transaction costs, such as the bid–offer spread, also carries potential difficulties. For fixed income securities or other securities primarily traded over the counter (OTC), the prices quoted on the bid or the offer may be only indicative. Absent firm, executable quotes on both sides of the market, the measurement of the spread and hence the reporting of indirect trading costs may be inaccurate or not reflective of true market conditions. Further complicating matters, the spread quoted by dealers in non-equity markets, such as bonds and derivatives primarily traded OTC, may embed other transaction costs. Therefore, quoted prices in dealer markets obfuscate separate identification of different transaction cost components.

For these reasons, the fund management industry has typically argued against the disclosure of transaction costs in pre-contractual information documents. From the investor's perspective, however, transaction costs are real costs that subtract from returns; without understanding the nature of these costs or knowing their approximate magnitude, any assessment of costs is incomplete.

In the United Kingdom, initiatives are under way to improve disclosures around transaction costs. In September 2012, the Investment Management Association (IMA), the U.K. trade association, recommended that unitised funds disclose three-year averages for broker commissions and any transfer taxes, expressed as a percentage of NAV.

6. Insurance Products with an Investment Component

The costs most commonly associated with insurance products with an investment component are presented in Section 6.1. In Section 6.2, example cost disclosures from selected products in different EU member states are analysed.

The labelling or wrapping of insurance products varies from one country to another in the EU, although in substance, insurance products are similar among EU member states. Regardless of the product or wrapper, insurance products with an investment component essentially involve taking a premium (or premiums) from the customer and investing it (them) in a portfolio of investments. The returns generated by the portfolio facilitate the payout to the customer under the terms of the event that the insurance policy underwrites.

Two of the most commonly sold types of insurance products with an investment component are life insurance policies and annuities. Life business accounts for the predominant share of the European insurance market; although other insurance products with an investment component may be sold in the EU, the salient features are captured by the subsequent analysis.

Life insurance (or assurance) products pay a designated beneficiary a sum of money upon the death of the insured person. Depending on the policy, the life insurance product may also pay the beneficiary under other “events,” such as critical illness. In other words, these products produce a state-contingent payoff that is derived from the returns generated by a portfolio of underlying securities and financial instruments. The payout may be fixed (guaranteed according to a predetermined formula) or variable depending on the nature of the scheme.

Life insurance is very flexible and can be adapted to a wide range of purposes. In addition to providing protection in the event of death or another event, life insurance products may be used to facilitate the growth of capital via the payment of regular premiums that are invested in a portfolio or fund(s). Examples include unit-linked life insurance, in which the premiums are used to purchase units in an underlying fund or portfolio (which determines the amount to be paid out), and with-profits life insurance, in which premiums are pooled with the insurance company’s life fund, thus allowing the policyholder to share in the profits of the insurance company.

Life insurance products enjoy favourable tax treatment (tax deferral and/or tax exemptions on payouts) in most EU jurisdictions.

Annuities provide a regular income stream to policyholders in exchange for an initial lump-sum payment (or sometimes a series of regular payments). The duration of the income stream from the annuity writer to the customer is linked to the individual's life span; as such, annuities are themselves a form of life insurance. Payments are set according to a predetermined formula and can be either fixed from year to year (at a level amount or indexed to the rate of inflation) or variable to allow for capital growth—that is, linked to the performance of an investment fund or portfolio. The income stream can also be immediate (payments commence upon receipt of the premium) or deferred to some future date. The type of annuity chosen determines the pricing (the annuity rate offered), the income stream to be received, and the level of risk. For example, annuities with variable income streams may provide higher potential payments but may carry a higher degree of risk.

One way in which annuities are purchased is by converting the terminal value of a defined contribution pension fund into an annuity. Upon retirement, the value accrued in the individual's pension fund can be exchanged for a regular income stream in the form of the annuity.

6.1. Costs

A holistic understanding of the costs and charges associated with life insurance products is challenging because the policies, wrappers, and underlying structures vary from one jurisdiction to another. Moreover, there is little available data on costs of insurance products and a lack of readily available information from product manufacturers and distributors. Consequently, a complete analysis is difficult.

At the product level, the fees and costs associated with life insurance basically stem from the establishment and administration of the policy and the costs associated with management of the investment portfolio or funds that the premiums are invested in.

The insurance company that writes the policy (also referred to as the insurance carrier) may charge an up-front establishment fee and an annual administration fee.⁹ These fees may be deducted from the value paid into or held in the client's account. Establishment and administration fees vary, although they typically do not exceed 1.5%. The insurance

⁹See, for example, Straub (2011).

company contracts with an asset manager (either part of the insurance group or a third party) who invests the premiums.¹⁰ The asset manager charges an annual management fee, typically up to 2% of the value invested, and sometimes a performance fee. The insurance company may also contract with a custodian bank, which charges safekeeping fees and possibly other account charges for custody of the assets. If the premiums are invested in other investment funds, as is common with unit-linked life insurance, then the typical fees and costs associated with investment funds are absorbed into the amount invested—such as the ongoing charges, transaction costs, and other expenses/charges outlined in Section 5. These costs also include possible exit charges or surrender charges for early termination of the policy.

There may also be fees or commissions associated with the sale of the product if sold via an adviser or intermediary. These intermediation costs, however, relate to the brokerage of the policy and are not specific to the product itself; that is, they relate to product distribution rather than product substance. There may be several layers of inducements between the different entities involved (insurance company, intermediary/adviser, asset manager, etc.) that are derived from the fees and charges emanating from the product. For the purpose of this analysis, however, we focus on the main product-level fees and charges.

The overall costs of life insurance vary widely. Straub (2011) conducted a scenario analysis in which the best-case, worst-case, and median-case scenarios of costs were calculated for setting up and maintaining a “typical” life insurance product. The median cost represents what is considered by the author as common practice in the industry. The author uses the following assumptions: a €1 million policy with the €1 million paid in a lump sum at inception, a 6% gross annual return on the underlying assets, and a balanced strategy of 40% equity, 40% bonds, and 20% alternative investments. The cost to the client over the first five years ranges from 40.70% of the paid-in premium (€407,000) in the worst-case scenario to 8.70% of the paid-in premium (€87,000) in the best case. The median costs are 20.14% of the paid-in premium (€201,375) over the first five years of the policy.

This worst-case scenario might be considered an outlier, but it highlights the extent to which charging structures can vary within life insurance wrappers. The range of outcomes presented is likely a function of the opaqueness of costs within life insurance products; it also emphasizes the adverse impact of costs on investors’ net returns.

¹⁰The policyholder may have the ability to choose among asset managers or the funds that the premiums will be invested with.

The costs associated with annuities are similar to those outlined for other types of life insurance. There is a small up-front cost for establishing the policy and, if relevant, administrative costs (or “ceding costs”) associated with the closure and transfer of a pension fund into an annuity. These administrative costs are borne by the life insurer and absorbed into the pricing of the policy (that is, the annuity rate offered).

If the annuity invests in investment funds, which is common practice, then the customer also bears (indirectly) the ongoing charges, transaction costs, other expenses, and possible entry or exit charges in connection with investment funds as outlined in Section 5.

Similarly, there may also be fees or commissions paid by the life insurer to the intermediary or adviser who brokers the annuity. These fees or commissions do not affect the annuity rate offered but may subtract from the amount annuitised by the customer.

Given that most of the costs of the annuity are embedded in the price or rate offered, it is difficult for retail investors to determine precisely how these costs affect their return (the income stream they receive).

Actuarial factors underpin the pricing of annuities, such as the age, health, and life expectancy of the policyholder; average mortality rates for annuitants; and assumptions about discount rates. Absent costs, the actuarial price of the annuity should equate the premium paid to the expected net present value of the income stream. That is, the ratio of the expected net present value to the premium would be 1.¹¹ A discount to 1, therefore, represents a cost to investors or a profit to the life insurer writing the annuity. Cannon and Tonks (2006) report that a variety of studies on different countries and time periods reveal that the ratio of the expected net present value to the premium is usually in the range of 0.85–1.05 (a value in excess of 1 implies losses for the insurer or that the insurer used different actuarial projections than those assumed in the net present value calculations in the study). Cannon and Tonks further report that less than 0.1 (10%) of the ratio is absorbed by life insurers’ costs.

6.2. Existing Disclosures

Currently, there is no single pre-contractual information document in the EU that summarises key information on insurance products. Pre-sale disclosure practices vary from one jurisdiction to another; furthermore, product information may be dispersed over several documents, potentially impairing transparency.

¹¹This ratio is often referred to as the “money’s worth.”

To inform possible policy options, some examples of existing product disclosures among selected EU member states follow.

Belgium

In Belgium, insurance companies provide summary product information via a document labelled “financial info sheet” (or “infofiche”). Although not mandatory, the info sheet supplements various pieces of national legislation concerning pre-contractual information on life insurance products. There are four product classes for which the info sheet may be produced:

- Branch 21 (products providing a guaranteed return; these products are not linked to investment funds),
- Branch 23 (life products linked to the return on investment funds),
- Branch 26 (covers capitalisation operations), or
- Combinations of the branches.

The info sheet sets out standardised information about the main characteristics of the product, including performance information and fees. The info sheet follows a standard format and must be accessible via the internet. An example financial info sheet for Branch 23 life insurance products is provided in Assuralia, Feprabel, UPCA/BVVM, and FVF (2012). Specifically, the cost disclosures include the following:

- Entry charge (including details about the entry fees—for example, $x\%$ on each payment)
- Exit charge (including details about exit fees)
- Management fees directly charged on the contract (including details about management fees—for example, $x\%$ per year on reserve)
- Surrender/withdrawal costs (including details about the procedures for surrender/withdrawal compensation)
- Fees for funds transfer (including details about fees linked to any funds transfer)

The standardised nature of cost disclosures within the financial info sheet facilitates comparability among retail investors.

Netherlands

The Netherlands Authority for the Financial Markets (AFM) has developed a product disclosure document called the “financial information leaflet” or “FB” (Financiële Bijsluiter). The FB is required for all sales of complex financial products, such as life insurance products, mortgages, and bank savings products, as well as structured products. The FB also applied to investment funds before being replaced by the KIID in 2012.

Product providers are required to file copies of their financial information leaflets with the AFM, which maintains a register of FBs on its website.¹²

The FB provides standardised disclosures, in a two-page document, of the key product characteristics, such as performance information, risks, and costs. There are five sections of the document:

1. What is the product?
2. What are the risks?
3. What are the costs?
4. What is the return?
5. What happens if the policy is terminated early?

Specifically, under “What are the costs?” the FB document presents the following information:

- a. Value invested (€)
- b. Premiums paid (€)
- c. Costs charged to the investor (€)
- d. Monetary return generated by the investment (€), assuming 4% growth
- e. Early termination costs, if any (€)
- f. What the investor receives ($a - b - c + d - e$), expressed in € and in % per annum

The data for categories (a) through (f) are presented in columns against three rows showing the outcomes after 1 year, 10 years, and 20 years, respectively.

¹²The Financiële Bijsluiter register is accessible at www.afm.nl/nl/professionals/registers/alle-huidige-registers.aspx.

The tabular presentation is relatively easy for investors to comprehend. The illustration of the impact of costs in monetary terms is also informative.

United Kingdom

In the United Kingdom, investment firms manufacturing packaged products (including investment trust saving schemes, life policies, stakeholder pensions, or personal pension schemes) are required to provide a key features document or illustration summarising the main product characteristics.¹³ Within key features, manufacturers are required to provide an “effect of charges” table, which illustrates the effect of deductions in monetary terms on the net return available to the investor. Additionally, firms are required to provide a “reduction in yield” (RIY) statistic. The RIY statistic shows the effect that total charges will have on the product’s potential rate of growth. The U.K. Financial Conduct Authority (FCA) stipulates the required charges information for packaged products, including the basis for the calculation of the effect of charges table and RIY, in its Conduct of Business Sourcebook (COBS) 13 Annex 3.

The effect of charges table shows the impact of charges over specified time periods.¹⁴ The effect of charges table must be accompanied by a statement that all relevant guarantees have been taken into account (where applicable), a warning that a retail client could get back less than he or she invests, and the rate of return used to calculate the figures in the table. COBS 13 Annex 3 (FCA 2007) details the components of the effect of charges table. An illustration of the effect of charges table for a life insurance policy follows.

At end of year	Total paid in to date £	Withdrawals £	Total actual deductions to date £	Effect of deductions to date £	What you might get back £
1					
...					
5					
10					
...					

¹³Key features also applied to collective investment schemes prior to the introduction of the KIID.

¹⁴For life insurance policies, the effect of charges must be shown for the first five years, every subsequent fifth year, and the final year of the projection period. For other packaged products, the effect of charges must be shown for the first year, the fifth year, and every subsequent fifth year of the projection period.

For other packaged products, the effect of charges table is set out as follows:

At end of year	Investment to date £	Income £	Effect of deductions to date £	What you might get back £
1				
5				
10				
...				

According to a report published by CRA International (Bovenzi, Malcolm, and Tilden 2008), commissioned by the U.K. Financial Services Authority (FSA),¹⁵ the effect of charges table has several benefits for retail investors. In particular, the effect of charges table makes it easier to compare and evaluate investment products and makes the impact of costs more tangible for retail investors.

Portugal

Pre-contractual disclosure requirements have been established in Portugal. The Portuguese Securities Commission (Comissão do Mercado de Valores Mobiliários, or CMVM) published Regulation No. 1/2009 (updated by Regulation No. 2/2012), which introduced an information document for complex financial products (CFPs), including unit-linked insurance contracts.

The pre-sale disclosure document was developed using the UCITS KIID model. The Portuguese KIID for CFPs is outlined in **Appendix B**.

Under the “Charges” section, the Portuguese KIID requires the following disclosures:

- Entry fees (including any subscription, acquisition, or initial transaction fees)
- Exit fees (including any redemption, reimbursement, or sale fees)
- Transfer fees and any penalties, where applicable
- Management fees

¹⁵The FSA is the predecessor of the FCA.

- Depositary fees
- Audit fees
- Other operating costs

For unit-linked insurance products, the KIID must also include

- the global costs rate (GCR, the ratio of total operating costs to the average net asset value of the CFP)¹⁶ and
- the average portfolio turnover (trading volume divided by average portfolio value).

The Portuguese KIID for CFPs must be no more than six pages long. It provides for somewhat more detailed information on costs than in other jurisdictions (given the requirement for an expense ratio or GCR, as well as a turnover ratio, for unit-linked insurance products). The document is informative from the perspective of providing a single KIID document applicable to all types of packaged (complex) products.

¹⁶Specifically, under CMVM Regulation No. 2/2012, the GCR is defined as “the quotient resulting from the sum of the management fee, deposit fee, auditing costs, and other operating costs, excluding transaction costs during a certain period, and the average net asset value of the CFP in said period.” The GCR “relates to the preceding calendar year, determined as at 31 December, and the calculation thereof should be ratified by the fund’s auditor.”

7. Structured Products

Structured products are investment instruments that provide a payout to the investor according to a predetermined formula at a specific future date. These products typically offer to repay the investor's capital and possibly some additional amount that is determined by a formula based on the change in the value of an underlying security, index, or basket of securities and financial instruments, measured between the offering date and the payout date. In essence, a structured product represents a contract between an investor and an issuer (typically a bank) that promises a set payout to the investor based on the performance of an underlying asset(s) or index.

The market for structured products has grown significantly in Europe over the past decade. According to a report by the Netherlands AFM (2007), the volume of structured products (in euros) sold to retail investors was a quarter of the market for collective investment schemes as of 2007. According to the same report, the largest European markets for structured product sales at that time were Italy, Germany, Belgium, and Spain. Those four countries, together with France and the United Kingdom, accounted for 80% of the European structured products market.

Structured products are largely sold on a bilateral basis between the issuing institution (such as an investment bank) and a retail customer via the usual intermediation channels for PRIPs. They come in a wide variety of forms, both substantively and legally according to the jurisdiction of issuance.

Structuredproductreview.com, a U.K.-based website service for IFAs, identifies three broad categories of structured products.

1. *Structured deposits.* These are fixed-term deposit accounts that offer a fixed return on the capital invested (a set percentage) provided that, at the end of the term, the index referenced is above its starting level.
2. *Structured capital-protected products.* Similar to structured deposits, these products are designed to provide a minimum return of the initial capital invested at maturity. But unlike deposits, these products may be structured as loans to the issuer and hence are not protected by deposit insurance schemes. The loan may be collateralised, in which case the investor will have some recourse to his or her money in the event of default on the part of the issuer. However, many structured products are not backed by a collateral pool.

3. *Structured capital-at-risk products.* As well as the potential for returning a predefined payout on the capital invested, these products carry the risk that capital will be lost under adverse market conditions. Because of their higher risk, these products offer potentially higher returns. Capital-at-risk products will often provide protection of capital up to a certain threshold (such as the reference index not falling by more than $x\%$ over the investment period, with losses of more than $x\%$ resulting in an equivalent loss of capital).

A key feature of almost all types of structured products is that the return available does not equate to the return on the underlying asset(s) or index on a strictly one-to-one basis. Because the potential return is predefined, the investor may end up receiving more or less than the return on the underlying asset(s) or index. For example, an investor may accept a potentially limited return in exchange for capital protection (which caps the investor's risk).

Within the aforementioned product categories, there are three general product types.¹⁷

- a. *Growth.* Provides for a fixed return (with or without capital protection) dependent on growth in the underlying asset(s) or index over the investment period. Participation may or may not be leveraged, for which the return is a multiple of the return in the underlying asset(s) or index, up to a maximum gain.
- b. *Income.* Provides for a regular income stream, which may be conditional on the underlying asset(s) or index remaining above a certain level.
- c. *Autocallable/kick-out.* An investment that may pay out prior to the maturity date if the return on the underlying asset(s) or index exceeds a certain level (or "barrier") on certain dates within the period. For example, if the reference index is above a specified barrier at the end of Year 1, the product "kicks out" and returns the original capital plus $z\%$. If not, the product is assessed at the end of Year 2, by which time it returns $2 \times z\%$ if the index is above a specified barrier. This process continues until the product reaches its maturity date.

The European Structured Investment Products Association (Eusipa) provides another classification.¹⁸ The Eusipa classification first differentiates between investment products and leverage products. Investment products are subcategorised into capital-protected products, yield-enhancement products, and participation products. Leverage products are subcategorised into leverage products with knock-out (kick-out), leverage products without

¹⁷For specific examples of product types, see "A Guide to Retail Structured Products" (www.structuredproductreview.com/Resources/Guide.pdf).

¹⁸See www.eusipa.org/categorisation.

knock-out, and constant leverage products. Within these six subcategories, Eusipa lists more than 20 different types of structured products. As this discussion implies, these products are numerous and diverse and their payoff functions are complicated. Consequently, the pricing of structured products is complex and opaque to the end investor.

The payoffs can be constructed with combinations of stocks, bonds, options, and futures. Mathematical models and statistical simulations that take into account the range of possible outcomes are used to price the products. As such, the underlying characteristics of these products are difficult for retail investors to comprehend. Moreover, there is substantial asymmetry of information and knowledge between the bank pricing the issues and the average retail investor purchasing them.

Because of the vast number of structured products and the limited trading of these instruments, it is difficult to find high-quality information on their pricing in either the primary or secondary markets.¹⁹ The fact that each product has unique characteristics—such as duration, payoff, capital guarantee, interest rate, reference asset(s) or index, credit risk of the issuer, and so forth—obfuscates product comparison and hinders the development of a liquid market.

7.1. Costs

The costs and charges associated with structured products are typically embedded in the price of the product. Because the pricing of these securities is complex, it is difficult for retail investors to ascertain the specific cost components or to compare costs among products.

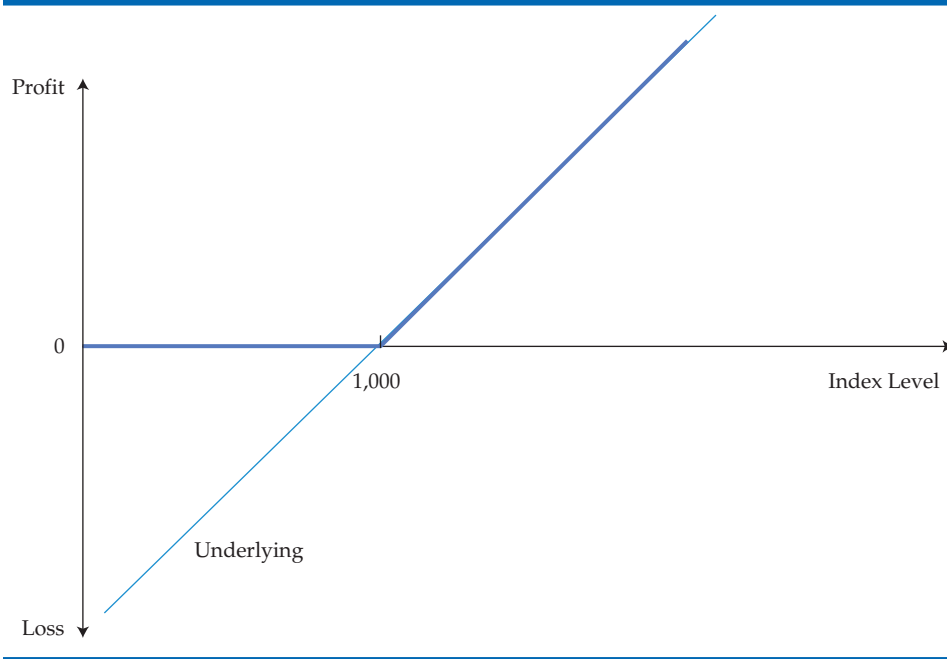
The costs embedded in structured products are derived from the combination of assets used to structure the products, particularly the derivatives held within the structure.

Bonds are the basic building block of many structured products. A bond with a fixed maturity and redemption at par provides a basis for the “loan” between the retail investor (effectively the bondholder) and the issuer. Whether the product provides a return in excess of the capital invested depends on the derivatives that are layered on top of the bond in the product structure. These structuring decisions influence the costs associated with the product.

¹⁹Relatively few issuers maintain a secondary market in the products they issue, partly because the products are placed with retail investors who typically hold them to maturity. Furthermore, the level of complexity of the products makes them difficult for market operators to monitor. Consequently, the secondary market for structured products is relatively illiquid.

The following hypothetical example illustrates a basic structured product and the associated cost components.²⁰ Consider a capital-protected structured product linked to an equity market index, with a fixed term of five years. At the end of the term, if the index is above where it was at the start of the period, the product returns the initial capital plus the percentage change in the index. If at the end of the term the index is below its starting level, the product returns the investor's initial capital. The product can be constructed with a zero-coupon bond with five years to maturity and a long call option with an exercise price equal to the initial index level.²¹ The zero-coupon bond provides the basis of the loan from the investor to the issuer and facilitates the repayment of capital, and the long call provides the investor with exposure to the index. The payoff structure for this product is illustrated in **Figure 6**, based on an initial index level of 1,000. The thick blue line represents the profit to the investor for different levels of the reference index.

Figure 6. Payoff Structure of a Capital-Protected Structured Product (Illustration)



²⁰The example provided is a simplified example intended to illustrate possible cost components. The product described does not purport to represent an actual structured product in issue.

²¹That is, buying an option to buy the index in five years' time at a price equal to the starting index level.

To examine the costs in this structure, assume further that the initial investment is €1,000, the bond redeems at par (100%) in five years' time and has a discount rate of 6%, the level of the stock index is 1,000 at the start of the period, the index volatility is 15%, and the risk-free interest rate is 3%. The components of the product are priced as follows.

The present value of the zero coupon bond (based on semiannual coupons) is

$$\frac{1,000}{(1 + 0.03)^{10}} = 744.09,$$

which amounts to 74.41% of par value.

The cost of purchasing the call option, which provides the upside exposure to the index, is €205.60.²²

The intrinsic value of the product to the investor is thus €744.09 + €205.60 = €949.69. After selling the product for €1,000, the issuer is left with a concession of €50.31, or 5.03% of the amount invested.

In summary, therefore, the explicit costs to the investor are as follows:

Purchase Bond	Purchase Index Exposure (call option)	Issuer Concession	Total Paid
€744.09	€205.60	€50.31	€1,000.00

The concession is essentially a charge that the issuer takes from the investor. It represents a markup on the value of the underlying components. This cost may or may not be disclosed to the investor up-front.

²²Let S denote the starting price of the index, X the exercise price of the option, r the risk-free interest rate, σ the volatility, and T the term of the product (in years). Therefore, $S = X = 1,000$, $r = 0.03$, $\sigma = 0.15$, and $T = 5$. According to the basic Black-Scholes-Merton model, the price of the call option (c) is

$$c = S \cdot N(d_1) - X e^{-rT} N(d_2) = 205.60$$

where $N(\cdot)$ represents the relevant probability density under the normal distribution and d_1 and d_2 are given by the following:

$$d_1 = \frac{\ln(S/X) + \left[r + \left(\frac{\sigma^2}{2} \right) \right] T}{\sigma \sqrt{T}}$$

$$d_2 = d_1 - \sigma \sqrt{T}$$

Further details supporting this example are provided in **Appendix C**, which illustrates the cash flows and payoffs to the issuer and investor, respectively, under hypothetical scenarios.

The stylised payoff from the product at maturity is summarised in the following table for given values of the index.

Index Level	Outcome	Return to Investor (€)	Return (%)
600	Bond redeems at par; call option expires out of the money. Investor gets back initial capital.	1,000	0
1,000	Bond redeems at par; call option expires at the money. Investor gets back initial capital.	1,000	0
1,400	Bond redeems at par; call option is exercised at 1,000, returning €400 (or 40%) above the starting level.	1,400	40
1,800	Bond redeems at par; call option is exercised at 1,000, returning €800 (or 80%) above the starting level.	1,800	80

The numbers used in the example, as well as the stylised product features, are for ease of illustration only. In reality, structured products can embody more complex features and hence embed other costs than just product structuring and markup.

Another cost structured products include is an opportunity cost in the form of the income that may be forgone on the underlying asset. In the example, the investor forgoes the dividends on the underlying index constituents. The foregone dividend yield is, therefore, an additional cost to the investor.

Other possible costs include the costs associated with the underlying asset. If the product is linked to investment funds, the typical costs associated with funds will reduce the net asset value of the underlying investment. Additionally, there could be performance fees associated with the product.

Some structured products contain annual charges—for example, if the underlying exposure is actively managed. If the underlying comprises a changing selection of investment funds, there may be a fee charged for the active management of that composition.

Investors in structured products also incur transaction charges if they sell their holding prior to maturity. As noted earlier, structured products are scarcely traded on the secondary market. Because so few issuers maintain a market in these securities, the products are relatively illiquid. As such, the spread between the bid and offer prices can be wide, implying high transaction costs. Moreover, in many cases, structured products are not traded at all, meaning that if an investor wants to sell the product back to the issuer, he or she must accept the value at which the issuer (the bank) would buy back the security. Without a liquid secondary market, it is difficult for the investor to determine whether the offered price is fair.

Furthermore, it is important to recognise that the derivatives underlying these products are often bespoke (not traded on exchanges). Therefore, the pricing of the derivatives can be subjective and dependent on assumptions made regarding such factors as interest rates, volatility, and so forth. The prices of the instruments are thus sensitive to changes in these assumptions. These factors make it difficult for investors to compare products and to ascertain whether the prices are appropriate.

Finally, there may be costs associated with the distribution of structured products, as with other types of PRIPs. However, as elsewhere in this report, we focus here on the product-level costs.

7.2. Existing Disclosures

Generally, there is a dearth of information available to investors on the costs associated with structured products. In many cases, only the issuer's margin/selling concession will be disclosed.

Pre-contractual disclosures on structured products are disparate within the EU. Common rules for prospectuses do apply to structured products, although distributors are not required to provide prospectuses when selling to retail investors. Distributors, however, are subject to conduct of business requirements and product suitability requirements under the Markets in Financial Instruments Directive.

Under the Prospectus Directive, a prospectus must be provided for structured securities that are “offered to the public or admitted to trading on a regulated market situated or operating within a Member State” (Directive 2010/73/EU). Under Article 1, the prospectus must include the following “key information”:

- (i) a short description of the risks associated with and essential characteristics of the issuer and any guarantor, including the assets, liabilities and financial position;
- (ii) a short description of the risk associated with and essential characteristics of the investment in the relevant security, including any rights attaching to the securities;
- (iii) general terms of the offer, including estimated expenses charged to the investor by the issuer or the offeror.

There are no specific requirements or guidelines on how “estimated expenses” should be presented to the investor. Moreover, prospectuses are lengthy and are not retail oriented, making them incomparable with pre-sale disclosure documents, such as the KIID.

National rules and disclosures regarding pre-contractual information on structured products vary widely. To exemplify a national initiative, disclosure practices in Germany are reviewed.

Germany

In Germany, the product information sheet (Produkt Information Blatt) entered into force in July 2011. The product information sheet applies to the distribution of certain types of retail investment products, including structured products, and must be provided to investors prior to the product being sold.

The German association of structured products providers—Deutscher Derivate Verband (DDV)—has published examples of how to present the product information sheet for 11 different types of structured products.²³ These sample sheets describe the essential characteristics of the relevant product over three pages, thus enabling investors to ascertain the key facts. An example of a product information sheet for a capital-protected cap certificate is presented in **Appendix D**. The following cost disclosures are excerpted from Section 6 of the DDV sample product information sheet for a capital-protected cap certificate (DDV 2011, Section 5).

²³See www.derivateverband.de/ENG/Transparency/ProductInformationSheets.

Costs/distribution fees:

The Initial Issue Price of the [product] as well as the bid and ask prices quoted by the Issuer during the lifetime are based on the Issuer's internal pricing models. In particular, these prices can include a margin which may cover, amongst other things, the costs for structuring the security, for the Issuer's risk hedging, and for distribution (kick-backs/benefits).

Costs of purchase and sale:

Where a fixed or determinable price has been agreed (fixed price transaction), fees and expenses for the purchase or the sale of the [product]—including external costs—are not charged separately. These are included in the fixed price.

Otherwise (commission transactions), fees for the purchase or the sale of the [product] in the amount agreed with the bank as well as any other fees and expenses (e.g., stock exchange fees) are charged separately.

Agio [premium]: EUR2.00 per Certificate

Ongoing costs:

Custody costs are to be paid in the amount agreed with the bank.

Kick-backs/benefits:

Placement commission: EUR1.25 per Certificate

Portfolio commission: none

Source: Deutscher Derivate Verband (2011).

As the excerpt indicates, structuring costs, issuer margin, and distribution costs are embedded in the pricing of the product. Transaction costs are also reflected in the price of the security. However, in this case, the product referenced includes other explicit costs, such as a premium on top of the offer price and a placement commission.

This example illustrates the range of possible costs associated with structured products and the difficulty of delineating these costs in a manner that is clear and comprehensible to the end investor. It also emphasizes the challenges associated with the ability to compare costs among products.

In other jurisdictions, cost disclosures can be less detailed. Most commonly, marketing materials merely reference the fact that all applicable charges have been built into the structure of the security.

8. Conclusions on Costs

The presentation of fees, charges, and costs is a key disclosure feature for investors that critically supports the investment decision-making process. Transparency over costs is essential to facilitate the purchase of suitable products by investors and to achieve an efficient allocation of savings.

But given the variety of PRIPs, as outlined in this report, presenting costs in a standardised, consistent manner in a way that is understood by consumers with limited investment knowledge is challenging.

Because product features vary, uniform cost disclosures across all products would be impractical. Instead, a minimum level of harmonisation should be sought with respect to cost disclosures to facilitate comparability to the fullest extent possible without compromising comprehension of specific product costs.

Accordingly, costs should be disclosed under a standard label and location within the KID, but the content of cost disclosures could embody a small degree of flexibility beyond common components. These disclosures should use the UCITS KIID (given its recent introduction) as the baseline.

Specifically, investment funds (including non-UCITS) cost disclosures should reflect the UCITS KIID requirements. The adequacy of certain KIID disclosures, however, should be reviewed as the PRIPs KID is developed.²⁴ For products linked to an investment fund, additional cost disclosures could be layered on top of the UCITS KIID requirements according to the packaging of the product. For example, unit-linked life insurance products are essentially investment funds wrapped in a life policy; at their core, they share common costs with investment funds, such as entry and exit fees and ongoing charges. However, the wrapping provided by the life insurance policy provides an additional layer of packaging and, potentially, additional costs. These include administration costs, early termination costs or penalties, and transfer fees (among other possible costs). The disclosures provided under Belgium's financial info sheet are informative in this regard.

²⁴The draft PRIPs regulation contains a transitional provision and review clause for the UCITS KIID. Specifically, the draft regulation provides for the continued use of the UCITS KIID for five years after entry into force of the PRIPs regulation, with a review to be undertaken of the effectiveness of the respective disclosures after four years.

Moreover, because life insurance policies can have relatively long time horizons compared with the typical holding period for other types of PRIPs, the cumulative costs associated with life insurance policies are likely to be commensurately greater (as are, potentially, the returns). Furthermore, the payout from these policies is uncertain and may be linked to an “event.” These factors necessitate additional disclosures that illustrate possible outcomes over fixed time periods for a given set of assumptions. The U.K. effect of charges table and the tabular disclosures in the Netherlands financial information leaflet provide informative illustrations of how costs can affect the returns on products with long time horizons.

Accordingly, for life insurance products, the standard UCITS KIID disclosures should be supplemented by any other packaging or termination costs and a tabular presentation that illustrates the effect of costs in monetary terms.²⁵ Given space constraints in the PRIPs KID, at a minimum, this type of disclosure should be signposted to a website containing the relevant information. For other types of life insurance products, such as with-profits in which premiums are commingled with the company’s life fund, the costs cannot be as cleanly delineated as for unit-linked policies. However, presentation of an expense ratio that is largely comparable with an ongoing charges figure should be permissible.

For investment products that embed all costs in their price, such as structured products, the UCITS KIID disclosures would not likely capture the primary cost elements. Specifically, one cannot compare UCITS ongoing charges with the structuring cost of a structured product (which is essentially the difference between the issuance price of the security and the present value, or fair value, of the underlying components at issuance). The former cost is an annual charge, whereas the latter may be a one-time occurrence at issuance. Moreover, structuring costs are somewhat subjective, to the extent that they can be engineered by the pricing of the derivatives in the product structure and influenced by the assumptions underpinning the derivatives construction. In comparison, UCITS ongoing charges are generally objective and specified in advance.

It would not be informative to present a disaggregated cost breakdown of all the underlying components of structured products in the KID; such detail may incur lengthy disclosure and would likely not be understood by the average retail investor.

²⁵Research suggests that illustration of the impact of charges over time in absolute numbers makes the impact on the investment easier to understand for retail investors. See Section 6.2 for details.

However, cost disclosures for structured products should include a narrative explanation of the total costs included in the amount paid for the product. For example, a sentence might explain that the issuance price includes an issuer concession or markup of $x\%$, or that the amount invested in the underlying assets or instruments is reduced by an equivalent amount of the explicit cost. In addition, disclosures should include numeric details of any fees and costs associated with buying or selling during the life of the product, as well as any early redemption or termination charges.

9. Other Considerations for the PRIPs KID

The draft regulation on PRIPs proposes that the format and content of KIDs should be standardised to facilitate comparability of key information and to support comprehension by retail investors. Drawing from the principles of the UCITS KIID regime, the draft regulation proposes predefined section headings that follow a set ordering:²⁶

- a. Name of the investment product and identity of the manufacturer.
- b. “What is this investment?” which includes the nature and main features of the product (such as the type of product and its objectives).
- c. “Could I lose money?” which includes information on any guarantees or capital protection and whether the product is covered by a financial compensation scheme.
- d. “What is it for?” which includes any recommended minimum holding period, the expected liquidity profile of the product, and the possibility and conditions for divestment prior to maturity.
- e. “What are the risks, and what might I get back?” which includes a summary indicator of the risk and reward profile of the product and warnings in relation to any specific risks.
- f. “What are the costs?” which includes both direct and indirect costs to be borne by the investor and summary indicators of these costs.
- g. “How has it done in the past?” which includes past performance information, if relevant, in regard to the nature of the product and the length of its track record.

In addition to costs, the sections on risks and past performance are of high importance from the perspective of retail investors’ comprehension and their ability to make informed decisions.

²⁶The European Commission’s original proposal included an additional section at the end of the KID for projections of possible future outcomes for certain types of pension products. This section was removed in amendments to the draft regulation in the European Parliament.

With regard to risk, the UCITS KIID approach provides a useful basis on which to develop a summary risk indicator and associated narrative disclosures for PRIPs (see Appendix A). The risk of the product, as reflected by the risk indicator, should incorporate its volatility. If volatility calculations (such as the standard deviation of returns) are not possible, either owing to the type of product or a lack of historical data, the KID should at least provide for adequate narrative disclosures of risk. Such disclosures should include an explanation of the risk associated with the product's benchmark or the index or asset(s) it references or is linked to. In the case of products with set maturities and predefined payoffs (such as structured products), risk should be measured with regard to the variability or range of possible outcomes at maturity, with appropriate disclosure of how this risk may vary during the life of the product (and hence, the risk associated with early redemption or exit from the product). Narrative disclosures should also include details of significant risks arising from the investment strategy of the product, details of any national financial compensation scheme protecting investors in the event of default or failure of the product manufacturer, and details of the creditworthiness of the issuer where appropriate.

For the purposes of the KID, it would be appropriate to present past performance data in an analogous manner to the UCITS KIID—namely, in the form of a bar chart that shows yearly net performance in percentage terms, alongside relevant narrative disclosures. These narrative disclosures should include (but would not be limited to) the basis of the return calculation, such as the measurement period; the treatment of any income arising over the period, such as whether income is reinvested or not; and the fees and costs that the return is net of. Specifically, return data should take into account ongoing charges and transaction costs.

Another important aspect of the past performance section of the KID is to limit the graphical presentation to only those products that have sufficient actual performance history. Proxy performance data, or simulated performance data, should not be used instead of, or linked to, actual performance history. The use of proxy data in place of actual data for years in which the product did not exist would be potentially misleading.

For structured or guaranteed products and funds, a tabular presentation of performance scenarios would be appropriate in place of past performance data. Disclosing a range of performance outcomes, if under predetermined, limited, and hypothetical scenarios that are appropriately labelled, can be effective in providing retail investors with an illustration of the possible outcomes from investment in structured or guaranteed products. Germany's product information sheet is informative in this regard (see Appendix D).

To facilitate comparability, the number and type of scenarios for structured funds and products should be prescriptive and made uniform in the KID. In addition, tabular performance scenarios should be accompanied by narrative disclosures stating clearly and prominently that these scenarios are manufactured and do not represent actual results.

Furthermore, because such information is prospective rather than historical, it would be misleading to include these disclosures within Section (g), “How has it done in the past?” The proposed PRIPs regulation provides for the disclosure of performance scenarios, where relevant, under Section (b), “What is this investment?” However, it may be more appropriate to include this information in Section (e), “What are the risks, and what might I get back?”; otherwise the labelling of the latter might be misleading.

10. Summary Policy Considerations

Based on the findings and conclusions in this report, we recommend the following policy considerations for the development of the PRIPs KID.

Scope

1. The initial scope of the PRIPs regime should be packaged products that provide for exposure to the performance of an underlying investment portfolio or other assets. Ultimately, the packaging provides the conduit for the investment exposure, and it is this packaging that determines the primary costs and other key features of the product. If, after review, the initial PRIPs KID is successful with consumers, the scope could be extended beyond packaged products.

Format

2. The PRIPs KID could use the UCITS KIID (given its recent introduction) as the baseline for developing the content of disclosures. The UCITS KIID disclosures could be tested against different types of PRIPs to determine how well these disclosures fit the product concerned. Appropriate amendments could then be made to the disclosure content based on product testing.
3. To allow flexibility, consideration should be given to setting a maximum length for the KID document, rather than a fixed number of pages. This approach would allow those products that require additional detail to be adequately disclosed, rather than left out or reduced to insufficient disclosures. The number of pages should, of course, be few (for example, a maximum of three pages) to maintain a concise presentation.

Costs

4. Costs should be disclosed under a standard label and location in the KID, but the content of cost disclosures could embody a small degree of flexibility beyond common components. Common components could include
 - ▲ entry fees (including any subscription, acquisition, or initial transaction fees);
 - ▲ exit fees (including any redemption, reimbursement, or sale fees);

- ▲ ongoing charges;
 - ▲ performance fees;
 - ▲ transfer fees, buying or selling charges, and any penalties, if applicable; and
 - ▲ any other administrative charges.
5. Cost disclosures should include a statement specifying the total amount in percentage terms that the product manufacturer or sponsor receives from distribution arrangements (inducements), if any.
 6. For life insurance products, a tabular presentation that illustrates the effect of costs in standardised monetary terms over predefined time horizons should also be provided. Given space constraints in the PRIPs KID, at a minimum, this type of disclosure should be signposted to a website containing the relevant information.
 7. Cost disclosures for structured products should include a narrative explanation of the total costs included in the amount paid for the product. For example, a sentence might explain that the issuance price includes an issuer concession or markup of $x\%$, or that the amount invested in the underlying assets or instruments is reduced by an equivalent amount of the explicit cost.
 8. Structured product disclosures should include standardised numeric details of any fees and costs associated with buying or selling the security during the life of the product, as well as any early redemption or termination charges.

Risks

9. The risk of the product, as reflected by the summary risk indicator, should incorporate its volatility. If volatility calculations (such as the standard deviation of returns) are not possible, either owing to the type of product or a lack of historical data, the KID should at least provide for adequate narrative disclosures of risk. Such disclosures should include an explanation of the risk associated with the product's benchmark or the index or asset(s) it references or is linked to.
10. In the case of products with set maturities and predefined payoffs (such as structured products), risk should be measured with regard to the variability or range of possible outcomes at maturity, with appropriate disclosure of how this risk may vary during the life of the product (and hence, the risk associated with early redemption or exit from the product).

11. Narrative disclosures should also include (among other things) details of significant risks arising from the investment strategy of the product, details of any national financial compensation scheme protecting investors in the event of default or failure of the product manufacturer, and details of the creditworthiness of the issuer where appropriate.

Performance

12. Past performance data should be presented in an analogous manner to the UCITS KIID—namely, in the form of a bar chart that shows yearly net performance in percentage terms, alongside relevant narrative disclosures. These narrative disclosures should include (but would not be limited to) the basis of the return calculation, such as the measurement period; the treatment of any income arising over the period; and the fees and costs that the return is net of. Specifically, return data should take into account ongoing charges and transaction costs.
13. Past performance information should be limited to those products that have sufficient actual performance history. Proxy performance data, or simulated performance data, should not be used instead of, or linked to, actual performance history.
14. For structured or guaranteed products and funds, a tabular presentation of performance scenarios would be appropriate in place of past performance data (located under a different section of the KID). To facilitate comparability, the number and type of scenarios for structured funds and products should be prescriptive and uniform in the KID.

Appendix A. UCITS KIID

Key Investor Information

This document provides you with key investor information about this fund. It is not marketing material. The information is required by law to help you understand the nature and the risks of investing in this fund. You are advised to read it so you can make an informed decision about whether to invest.

123 Fund, a sub-fund of ABC Fund SICAV (ISIN: 4321) This fund is managed by ABC Fund Managers Ltd, part of the XYZ group of companies	
Objectives and Investment Policy	
Joint description of the objectives and policy of the UCITS in plain language (it is suggested not to copy-out the prospectus) Essential features of the product which a typical investor should know: <ul style="list-style-type: none"> • main categories of eligible financial instruments that are the object of investment • a statement that the investor may redeem units on demand, and how frequently units are dealt in • whether the UCITS has a particular target in relation to any industrial, geographic or other market sectors or specific classes of assets • whether discretionary choices regarding particular investments are allowed, and whether the fund refers to a benchmark and if so which one • a statement of whether any income arising from the fund is distributed or reinvested 	Other information if relevant, such as: <ul style="list-style-type: none"> • what type of debt securities the UCITS invests in • information regarding any pre-determined pay off and the factors expected to determine performance • if choice of assets is guided by growth, value or high dividends • how use of hedging / arbitrage / leverage techniques may determine the fund's performance • that portfolio transaction costs will have a material impact on performance • minimum recommended holding term
Risk and Reward Profile	
Narrative explanation of the indicator and its main limitations: <ul style="list-style-type: none"> • Historical data may not be a reliable indication for the future • Risk category shown is not guaranteed and may shift over time • The lowest category does not mean 'risk free' • Why the fund is in its specific category • Details of nature, timing and extent of any capital guarantee or protection 	Narrative presentation of risks materially relevant to the fund which are not adequately captured by the indicator: <ul style="list-style-type: none"> • Credit risk, where a significant level of investment is made in debt securities • Liquidity risk, where a significant level of investment is made in financial instruments that are likely to have a low level of liquidity in some circumstances • Counterparty risk, where a fund is backed by a guarantee from, or has material investment exposure through contracts with, a third party • Operational risks including safekeeping of assets • Impact of any techniques such as derivative contracts

Charges for this Fund

The charges you pay are used to pay the costs of running the fund, including the costs of marketing and distributing it. These charges reduce the potential growth of your investment.

One-off charges taken before or after you invest	
Entry charge	[]%
Exit charge	[]%
This is the maximum that might be taken out of your money [before it is invested][before the proceeds of your investment are paid out].	
Charges taken from the fund over a year	
Ongoing charges	[]%
Charges taken from the fund under certain specific conditions	
Performance fee	[]% a year of any returns the fund achieves above the benchmark for these fees, [insert name of benchmark].

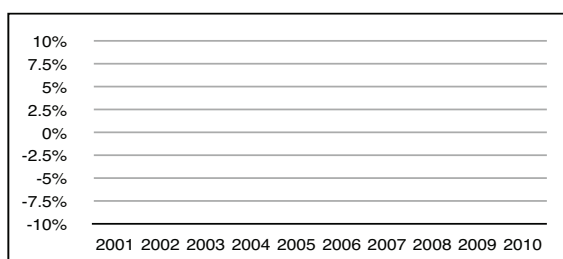
The **entry and exit charges** shown are maximum figures. In some cases you might pay less - you can find this out from your financial adviser.

The **ongoing charges** figure is based on expenses for the year ending []. This figure may vary from year to year. It excludes:

- Performance fees
- Portfolio transaction costs, except in the case of an entry/exit charge paid by the UCITS when buying or selling units in another collective investment undertaking

For more information about charges, please [see pages x to x / section x] of the fund's prospectus, which is available at www.ucitsfund/prospectus

Past Performance



The chart will be supplemented with prominent statements which:

- warn about its limited value as a guide to future performance
- indicate briefly which charges have been included or excluded
- state the year when the fund started to issue units
- indicate the currency in which past performance has been calculated.

Practical Information

- Name of the depositary
- Where and how to obtain further information about the UCITS (prospectus, reports & accounts)
- Where and how to obtain other practical information (e.g. where to find latest unit prices)
- A statement that tax legislation of the fund's Home State may have an impact on the personal tax position of the investor
- A statement that "[Name of management company] may be held liable solely on the basis of any statement contained in this document that is misleading, inaccurate or inconsistent with the relevant parts of the prospectus for the fund"
- Specific information relating to umbrella funds (e.g. any switching rights between sub-funds)
- Information about other share classes, if applicable (KII may be based on a representative class)

This fund is authorised in [name of Member State] and regulated by [identity of competent authority].

[Name of management company] is authorised in [name of Member state] on and regulated by [identity of competent authority].

This key investor information is accurate as at [the date of publication].

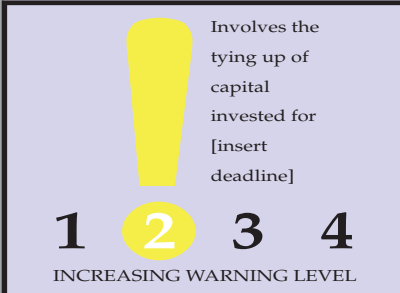
Source: CESR (2010b).

Appendix B. KIID for Complex Financial Products (Portugal)

Key Investor Information Document

COMPLEX FINANCIAL PRODUCT

A responsible investment requires that you know all the implications and are willing to accept said implications.

<p style="text-align: center;"><i>Field to insert:</i></p> <p style="text-align: center;"><i>Name of the CFP and, where available, the ISIN Code</i> [Information envisaged in Article 8/2/c]</p> <p style="text-align: center;"><i>Clear identity of the issuer or management entity, as applicable</i> [Information envisaged in Article 8/2/d]</p>	<p style="text-align: center;"><i>[Field to insert Warning Symbol envisaged in Article 9 and Annex II] [Example Shown]</i></p> <div style="text-align: center; border: 1px solid black; padding: 5px;"> <p style="font-size: small;">All Investments Carry Risk</p>  <p style="font-size: x-small;">Please see KIID/Prospectus available at www.cvm.pt</p> </div>
Specific Investor Warning Notices	
[Warning Notices envisaged in Article 10]	
Handwritten text: <i>I have taken note of the warning notices</i>	
Date: _____ Time: _____ Client signature: _____	
Description and Main Features of the Product	
[Information envisaged in Article 11]	
Key Risk Factors	
[Information envisaged in Article 12 and Annex III]	
Scenarios and Probabilities	
[Information envisaged in Article 13]	
Charges	
[Information envisaged in Article 14]	
Historical Returns and Risks	
[Information envisaged in Article 15]	
Additional Information	
[Information envisaged in Article 16]	
Handwritten text: <i>I received a copy of this document before [acquisition or initial transaction].</i>	
Date: _____ Time: _____ Client signature: _____	

Source: CMVM (2012).

Appendix C. Structured Product Payoffs (Illustration)

The following table illustrates the cash flows and payoffs to the issuer and investor, respectively, for hypothetical outcomes from the structured product explained in Section 7.1.

Description	Issuer (€)	Investor (€)
Start: Index = 1,000		
Sell product to investor	1,000.00	-1,000.00
Purchase zero-coupon bond	-744.09	
Purchase call option	-205.60	
Net cash flow	50.31	-1,000.00
#1 End: Index = 600		
Zero-coupon bond redeems	1,000.00	
Repay investor's capital	-1,000.00	1,000.00
Exercise call option	—	
Net cash flow	—	1,000.00
Net return	50.31	—
Net return (%)	5.03%	0.00%
#2 End: Index = 1,000		
Zero-coupon bond redeems	1,000.00	
Repay investor's capital	-1,000.00	1,000.00
Exercise call option	—	
Net cash flow	—	1,000.00
Net return	50.31	—
Net return (%)	5.03%	0.00%

#3 End: Index = 1,400		
Zero-coupon bond redeems	1,000.00	
Repay investor's capital	-1,000.00	1,000.00
Exercise call option (buy index)	-1,000.00	
Sell index	1,400.00	
Return of index gains to investor	-400.00	400.00
Net cash flow	—	1,400.00
Net return	50.31	400.00
Net return (%)	5.03%	40.00%
#4 End: Index = 1,800		
Zero-coupon bond redeems	1,000.00	
Repay investor's capital	-1,000.00	1,000.00
Exercise call option (buy index)	-1,000.00	
Sell index	1,800.00	
Return of index gains to investor	-800.00	800.00
Net cash flow	—	1,800.00
Net return	50.31	800.00
Net return (%)	5.03%	80.00%

Appendix D. Product Information Sheet (Germany)

Product information sheet

Regarding financial instruments in accordance with the German Securities Trading Act (Wertpapierhandelsgesetz, WpHG)



As of: 24 May 2011

This document provides an overview of the essential characteristics of the capital investment, in particular those relating to its structure and risks. We advise potential investors to read carefully the information provided.

Capital Protected Cap Certificate linked to the I-Index

German securities code (WKN): XYN34R/ISIN: DE000XYN34R4

Issuer: XY-Bank

1. Product description/functionality

Product class

Capital Protection Certificate (bearer bond)

General description of functionality

With this Capital Protected Cap Certificate, the entitlement of the investor depends on the Index Performance. On the Maturity Date, the investor receives at least the Capital Protection Amount and at most the Maximum Amount.

- If the Reference Price is equal to or below the Strike, the investor receives the Capital Protection Amount on the Maturity Date.
- If the Reference Price is above the Strike but below the Cap, the investor receives, on the Maturity Date, a Cash Amount corresponding to EUR 100.00 multiplied by the Index Performance.
- If the Reference Price is equal to or above the Cap, the investor receives the Maximum Amount on the Maturity Date.

During the lifetime, the investor does not receive any regular income (e. g. dividends or interest).

Investment objectives and strategy/market expectation (optional)

The Capital Protected Cap Certificate is aimed at investors who assume that the price of the Index will rise slightly, however, who also want to hedge against possible losses at the end of the lifetime.

2. Product data

Explanations of the terms used can be found at www.derivateverband.de under the heading "Knowing the facts".

Underlying (German securities code – WKN/ISIN)	I-Index (calculated by IS as index sponsor) (123456/DE0001234561)	Initial Valuation Date	31 March 2010
Currency of the Capital Protected Cap Certificate	EUR	Final Valuation Date	31 March 2016
Subscription Period	2 March 2010 to 2 April 2010	Strike	closing price of the Index on the Initial Valuation Date
Issue Date	6 April 2010	Reference Price	closing price of the Index on the Final Valuation Date
Initial Issue Price	EUR 100.00 plus Agio	Maturity Date	three banking days following the Final Valuation Date
Agio	EUR 2.00	Index Performance	Reference Price + Strike
Capital Protection Amount	EUR 100.00	Minimum Trading Unit	1 Certificate
Cap (Index)	160% of Strike	Stock Exchange Listing	Stuttgart (EUWAX), Frankfurt (Scoach Premium)
Maximum Amount (Certificate)	EUR 160.00	Last Exchange Trading Day	30 March 2016

3. Risks

Risks at the end of the lifetime

Due to the capital protection, the risk at the end of the lifetime is limited to the Issuer risk (see below).

Market price risk during the lifetime

The value of the Capital Protected Cap Certificate during the lifetime can be adversely affected in particular by the factors determining the market price as referred to in item 4 and can also be substantially below the purchase price.

Creditworthiness/Issuer risk

Investors are exposed to the risk of the Issuer becoming insolvent, and thus failing to pay. Details of the relevant Issuer rating can be found at www.beispieleseite.de. As a bearer bond, the Capital Protected Cap Certificate is not subject to any deposit protection.

4. Availability

Tradability

During the Subscription Period, the investor can place a purchase order for the Certificate with his bank. After the Issue Date, the Capital Protected Cap Certificate can, as a rule, be bought or sold on an exchange or in the over-the-counter-market. The Issuer will continually quote indicative bid and ask prices for the Capital Protected Cap Certificate under normal market conditions (market making), without being under a legal obligation to do so. In unusual market situations, or in the event of technical problems, it may be difficult or impossible to purchase or sell the Capital Protected Cap Certificate temporarily.

Factors determining the market price during the lifetime

The value of the Capital Protected Cap Certificate during the lifetime can be substantially below the purchase price.

The market price of the Capital Protected Cap Certificate depends primarily on the Index Performance, however, without necessarily tracking such performance exactly.

The following circumstances, in particular, may have an additional impact on the market price of the Capital Protected Cap Certificate:

- changes in the volatility level of the price of the Index;
- remaining lifetime of the Capital Protected Cap Certificate;
- general changes of interest rates;
- dividend performance of the shares included in the Index;
- change of the creditworthiness of the Issuer.

Individual market factors can have a mutually amplifying or neutralising effect.

5. Opportunities and scenario analysis by way of example

The following examples apply as at the end of the lifetime. They are not an indicator of the actual performance of the Capital Protected Cap Certificate. **Assumed Strike: 3,000 index points**

Reference Price	Index Price Gain/Index Price Loss	The investor receives per Capital Protected Cap Certificate
5,400	+80%	EUR 160.00
4,800	+60%	EUR 160.00
3,600	+20%	EUR 120.00
3,000	+/-0%	EUR 100.00
2,100	-30%	EUR 100.00
1,000	-66.7%	EUR 100.00
500	-83.3%	EUR 100.00
0	-100%	EUR 100.00

Purchasing at the Initial Issue Price:

Positive development for the investor

Neutral development for the investor

6. Costs / distribution fees

The Initial Issue Price of the Capital Protected Cap Certificate as well as the bid and ask prices quoted by the Issuer during the lifetime are based on the Issuer's internal pricing models. In particular, these prices can include a margin which may cover, amongst other things, the costs for structuring the security, for the Issuer's risk hedging, and for distribution (kick-backs/benefits).

Costs of purchase and sale

Where a fixed or determinable price has been agreed (fixed price transaction), fees and expenses for the purchase or the sale of the Capital Protected Cap Certificate – including external costs – are not charged separately. These are included in the fixed price. Otherwise (commission transactions), fees for the purchase or the sale of the Capital Protected Cap Certificate in the amount agreed with the bank as well as any other fees and expenses (e. g. stock exchange fees) are charged separately.

Agio: EUR 2.00 per Certificate

Ongoing costs

Custody costs are to be paid in the amount agreed with the bank.

Kick-backs / benefits

Placement commission: EUR 1.25 per Certificate

Portfolio commission: none

7. Taxation

Investors are advised to consult a tax advisor in order to clarify any individual tax effects of purchasing, holding, selling and /or redemption of the Capital Protected Cap Certificate.

8. Miscellaneous information

The product information contained in this product information sheet does not constitute a recommendation on our part to purchase or sell the Capital Protected Cap Certificate, nor can it replace the advice provided on a one-to-one basis by the bank or an advisor of the investor. This product information sheet does not contain all information relevant to the Capital Protected Cap Certificate. For full information – and in particular regarding the details of the structure of and risks associated with an investment in the Capital Protected Cap Certificate – potential investors should read the securities prospectus which (together with the final terms as well as any supplements, if any) are available from the XY-Bank free of charge, or may be downloaded from our website at www.xy-bank.de.

Source: Deutscher Derivate Verband (2011); retrieved May 2013.

Bibliography

Assuralia, Feprabel, UPCA/BVVM, and FVF. 2012. “Code of Good Conduct for Advertising and Providing Information about Individual Life Insurance Products” (9 March): <http://info.verzekeringen.as/codeofgoodconduct.pdf>.

Bethel, J., and A. Ferrell. 2006. “Policy Issues Raised by Structured Products.” Discussion Paper No. 560, John M. Olin Center for Law, Economics and Business, Harvard Law School (October).

Bovenzi, F., K. Malcolm, and M. Tilden. 2008. *Benefits of Regulation: Effect of Charges Table and Reduction in Yield*. CRA International (March).

Cannon, E., and I. Tonks. 2006. *Survey of Annuity Pricing*. Department for Work and Pensions Research Report No. 318.

CESR. 2010a. “CESR’s Guidelines on the Methodology for Calculation of the Ongoing Charges Figure in the Key Investor Information Document.” CESR/10-674, Committee of European Securities Regulators (1 July): http://www.esma.europa.eu/system/files/10_674.pdf.

———. 2010b. “CESR’s Template for the Key Investor Information Document.” CESR/10-1321, Committee of European Securities Regulators (December): http://www.esma.europa.eu/system/files/10_1321.pdf.

CMVM. 2012. “CMVM Regulation No. 2/2012 Disclosure Duties Relating to Complex Financial Products and Marketing of Unit-Linked Insurance Plans.” Comissão do Mercado de Valores Mobiliários (25 October): www.cmvm.pt/EN/Legislacao_Regulamentos/Regulamentos%20Da%20Cmvm/2012/Documents/RegulamentoPFC2_2012E.pdf.

CEIOPS. 2009. *Report on National Measures regarding Disclosure Requirements and Professional Requirements for Unit-Linked Life Insurance Products, which Are Additional to the Minimum Requirements of the CLD and IMD*, Committee of European Insurance and Occupational Pensions Supervisors (July).

DDV. 2011. “Product Information Sheet: Capital Protected Cap Certificate.” Deutscher Derivate Verband (24 May): <http://www.derivateverband.de/ENG/Transparency/ProductInformationSheets>; retrieved May 2013.

Decision Technology. 2010. *Consumer Decision-Making in Retail Investment Services: A Behavioural Economics Perspective*. Report for the European Commission (November): http://ec.europa.eu/consumers/strategy/docs/final_report_en.pdf.

European Parliament and Council. 2010. “Directive 2010/73/EU.” *Official Journal of the European Union* (24 November): http://ec.europa.eu/internal_market/securities/prospectus/index_en.htm.

European Commission. 2012. “Impact Assessment Accompanying the Document Proposal for a Regulation of the European Parliament and of the Council on Key Information Documents for Investment Products.” European Commission Staff Working Document (July).

ESMA. 2013. *Retailisation in the EU*. European Securities and Markets Authority, Economic Report, no. 1 (3 July).

Financial Conduct Authority. 2007. “Conduct of Business Sourcebook” (November): <http://fshandbook.info/FS/html/FCA/COBS>.

IMA. 2012. “Enhanced Disclosure of Fund Charges and Costs.” Investment Management Association (September).

IOSCO. 2013. *Regulation of Retail Structured Products*. International Organization of Securities Commissions, CR05/13 (April).

LECG. 2009. “The Regulation of Retail Investment Products: An Initial Assessment of the Impact of Recent Changes” (May).

McCann, C., and D. Luo. 2006. “Are Structured Products Suitable for Retail Investors?” Securities Litigation and Consulting Group (November).

Netherlands Authority for the Financial Markets. 2007. *Exploratory Analysis of Structured Products* (4 May).

Straub, M. 2011. “Unit-Linked Life Insurance: Cost Drivers, Hidden Payments, and the Tax-Deferral Argument.” *Conference Proceedings Quarterly*, vol. 28, no. 4 (December):48–57.



CFA Institute

AUTHOR

Rhodri Preece, CFA
Director
Capital Markets Policy

CONTRIBUTORS

Kurt N. Schacht, JD, CFA
Managing Director
Standards and Financial
Market Integrity

Claire Fargeot
Head
Standards and Financial
Market Integrity, EMEA

ACKNOWLEDGEMENT

We would like to thank Agnès Le Thiec, CFA, for helping to develop this study and for contributing research.

THE AMERICAS

(800) 247 8132 PHONE (USA and Canada)

+1 (434) 951 5499 PHONE

+1 (434) 951 5262 FAX

560 Ray C. Hunt Drive
Charlottesville, VA 22903-2981
USA

477 Madison Avenue
21st Floor
New York, NY 10022-5802
USA

ASIA PACIFIC

+852 2868 2700 PHONE

+852 8228 8820 INFO HOTLINE

+852 2868 9912 FAX

23/F, Man Yee Building
68 Des Voeux Road
Central, Hong Kong SAR

EUROPE

+44 (0) 20 7330 9500 PHONE

+44 (0) 20 7330 9501 FAX

131 Finsbury Pavement
7th Floor
London EC2A 1NT
United Kingdom

Square de Meeûs 38/40
1000 Brussels, Belgium

