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AMF

Outcome of the public consultation on the provision of future performance simulations to investors

From 24 November 2016 to 20 January 2017, the AMF held a public consultation on the provision of future performance simulations to investors in the context of marketing investment solutions.

Given the risks of poor design on the part of investment firms and misunderstanding on the part of investors, the aim of this consultation was to gather opinion from all interested parties on methods that could be used to govern the information disseminated, in light of applicable regulations, and on the need to specify practices appropriate to the use of simulation tools.

The positions recounted in this document are taken purely from responses to the consultation. The AMF's proposals are set out at the end of the document.

1. Responses received

The AMF received 16 responses from various professionals:

- four French asset management companies
- one financial investment adviser
- nine representative industry groups
- one unregulated entity
- one other non-profit organisation

2. Reminder of proposals

In the context of the consultation, the AMF put forward three proposals:
- To clarify and harmonise the rules applicable to all professionals, whether investment services providers, including asset management companies, financial investment advisers or crowdfunding investment providers, that stem from the requirement to provide information that is fair, clear and not misleading and that is common to all;
- To recommend including a standardised message to warn investors that simulations are educational tools and not guarantees of a given level of return;
- To publicise best and worst practice with regard to the design of simulations and the definition of the assumptions that underpin them.

3. Summary of responses by question

3.1 Question 1 – Harmonisation of rules: Do you agree with the proposal to harmonise rules and best practice set out in point A of the Annex?

Summary of point A of the Annex

A – Subjecting all professionals to the same regulation – Proposal to extend Articles 314-10 to 314-17 to financial investment advisers

Article 325-5 of the AMF General Regulation
All information, including advertisements, sent by a financial investment adviser shall be fair, clear and not misleading.
The content of information must comply with Articles 314-10 to 314-17.

<u>Proposal to amend Article 314-15 of the AMF General Regulation</u>

Article 314-15 of the AMF General Regulation
Where the information contains information on future performance, the following conditions shall be satisfied:

1. The information must not be based on or refer to simulated past performance.

2. It must be based on reasonable assumptions supported by objective data.

3. Where the information is based on gross performance, the effect of commissions, fees or other charges must be disclosed.

4. The information must contain a prominent warning that such forecasts are not a reliable indicator of future performance.

Article 314-14 relating to past performance would not be changed.

The vast majority of professionals who responded to the consultation (15 out of 16) said they were in favour of harmonising the rules applicable to all operators using online performance simulators to market investment products and provide investment services, on the grounds that this would ensure fairer competition irrespective of each operator's status or the type of regulation.

Only one operator expressed an unfavourable opinion: it considered that the issue is not whether to harmonise rules across all professionals but rather the decisions made by professionals in choosing a status corresponding to the services provided, in accordance with regulatory constraints.

A number of responses raised the question of how the first paragraph of Article 314-15 of the AMF General Regulation, which prohibits the use of simulations of past performance, relates to:

- preparatory work ahead of implementation of the PRIIPS Regulation, which provides for the calculation of future performance scenarios by extrapolating past performance;
- industry practice in relation to financial modelling.

However, in spite of the relevance of these comments, the wording of Article 314-15 of the AMF General Regulation results from the literal transposition of MiFID and, given ongoing discussions over future regulatory developments such as MiFID II and PRIIPS, it does not appear desirable to anticipate changes in the wording.

3.2 Question 2 – Insertion of a standardised box: Do you agree with this recommendation, set out in an ad hoc *policy document in the form presented in point B1 of the Annex?*

Summary of point B of the Annex

B – <u>Drafting an *ad hoc* policy document</u>

AMF Recommendation
Simulating future performance – DOC-2016-XX

Reference documents: Article L.533-12 of the Monetary and Financial Code, Articles 314-10 to 314-17, 325-5 and 325-36 of the AMF General Regulation.

As part of its focus on technological innovation, the AMF has noted the emergence of wholly digital services offered by professionals to their investors.

We have seen in some cases that these professionals provide their investors and prospects with technological tools that enable them to draw up their own financial positions. This involves prospects filling out standardised questionnaires online in which they are usually asked to set an initial investment amount and the amount they wish to invest per month after that, choose a risk profile or investment vehicle and define the investment value they would like to obtain over a given horizon. The tool's algorithms then generate projections for the client's investment value under various scenarios, ranging from the most pessimistic to the most optimistic.

The AMF intends that this document reminds professionals investment, whether they be service providers, including asset management companies, financial investment advisers or crowdfunding investment providers, of what is required by the regulations and how they should be interpreted.
This document is also intended to provide recommendations for implementation.

1. Investor information on future performance simulators

Recommendation

To minimise the risk of misunderstanding, firms wishing to use a future performance simulation tool would be recommended to require the client to confirm that a 'health warning' message has been read before charts are displayed.

It is recommended that the message below be displayed legibly, on the same screen as the chart and in a box in clearly readable bold type.

The illustration shown is not a forecast of the future performance of your investments. This chart is based on estimates specific to [professional's name] and has educational value to illustrate the way your investment works.

The value of your investment could diverge significantly from the results shown. The most unfavourable scenario shown is not a reliable measure of your maximum possible loss, which could be the full amount of capital invested[1].

The most favourable scenario does not constitute the exact return on your portfolio. Performance could diverge from this curve, upwards or downwards.

By remaining on this site, you confirm that you acknowledge this warning, understand it and accept its content.

It is recommended that this message should not be visible only after scrolling down the page.

As was the case for question 1 on the harmonisation of rules applicable to all professionals, the majority of responses to question 2 of the consultation (12 out of 16) approved of the inclusion of a disclaimer intended to inform investors of the scope of simulations and ensure that they are not understood to be guarantees of future performance.

Only three professionals objected to the adoption of a standardised message, finding that such a solution would add no value and would probably be ineffective.

However, while most professionals who responded to the consultation considered the principle of including a disclaimer to be relevant, it appears that the proposed wording may not be suitable as it stands.

[1] Except for guaranteed products.

Firstly, some respondents reiterated that simulations are not necessarily shown in chart form; they may also be shown as tables or figures.

Secondly, professionals drew the AMF's attention to the risk of purely and simply disqualifying future performance simulators by adding an additional disclaimer and making such digital solutions less user-friendly.

If browsing were restricted or the credibility of simulation results undermined, investors would likely be less interested in the proposed investment solution and spurn the tool, and this would undoubtedly hamper all efforts at investor education.

Furthermore, the addition of the window, combined with the length of the message, might not be technically compatible with devices with smaller screens (tablets, smartphones, etc.).

In this sense, if it is to be read and understood, the disclaimer must be simple and of an acceptable length, and must avoid technical terms.

The responses also highlighted that including an overly aggressive standardised message could unduly worry investors. The disclaimer as currently worded is liable to worry clients disproportionately: "The most unfavourable scenario shown is not a reliable measure of your maximum possible loss, which could be the full amount of capital invested"; the risk of capital loss is already stated in regulatory documents and marketing materials for financial products.

Lastly, one response emphasised the need to distinguish online simulations from face-to-face simulations; in the latter case, an message displayed on-screen is of little interest, since the document containing the chart is printed out and handed to the client once the simulation has been run.

3.3 *Question 3 – Publication of best and worst practice: Do you agree with this recommendation, set out in an* **ad hoc** *policy document in the form presented in point B2 of the Annex?*

Summary of point B of the Annex

2. Technical aspects of designing future performance simulators

It seems that some future performance simulation tools are based on unrealistic assumptions that are liable to lead to the dissemination of potentially misleading and overly optimistic information.
Cases have been observed in which professionals communicate on a highly unfavourable scenario for which an investment consisting of money market assets is illustrated using manifestly disproportionate annual performance data, while others use inappropriate short-term discount rates.

Recommendation

The AMF recommends that the following best and worst practice be taken into account:

- Performance simulations are based on realistic market assumptions;
- The volatility assumptions used in a future performance simulation chart are consistent with the investment period being simulated;
- A simulation takes account of the investment horizon and is based on reasonable market assumptions consistent with that horizon (interest rates, volatility, inflation, etc.) founded in objective factors;
- Given that a simulation based on long-term interest rate assumptions must be consistent with future performance simulations, a five-year return can be simulated only on the basis of five-year interest rates and not on the basis of interest rates over shorter or longer maturities.

With the exception of one respondent who considered this policy proposal redundant, difficult to understand and unrealistic, all professionals who responded to the consultation supported the AMF's proposal that best and worst practice be published by way of policy, to ensure that performance simulations do not give rise to information that is clearly misleading to clients.

However, a number of responses emphasised that certain recommendations might appear inappropriate:

- According to some respondents, the second recommendation, according to which the volatility assumptions used should be consistent with the investment horizon being simulated, must not be understood as a requirement for risk measurement to vary with maturity. Indeed, unusual volatility phenomena can be observed over short periods (from a few months to a year), thus skewing simulation results. According to three responses, therefore, it should be clarified or recommended that the assumptions must be consistent with the underlying assets and defined over a long period.
- According to some respondents, the fourth recommendation could suggest that only five-year interest rates can be used to simulate a five-year investment. As one professional illustrated, this is not necessarily appropriate for a diversified portfolio whose objective is to outperform, or generate lower volatility than, one of the assets making up the portfolio.

  Similarly, it has emerged that the recommendations are not always appropriate to all types of underlyings (e.g. real estate).

  Consequently, the recommendations must be sufficiently standardised that they can be applied to all types of investment.

Lastly, one professional argued for greater transparency, to encourage producers of performance simulations to disclose their assumptions. However, since it would not result in the dissemination of information that is intelligible to all users, this proposal could not be adopted for retail clients.

4. Conclusions: the AMF's proposals

Following the consultation, the AMF has decided to amend its General Regulation, with the aim of:

(i) extending to financial investment advisers the rules applicable to all other regulated professionals regarding disclosures to clients; and

(ii) correcting the non-literal transposition, in the fourth paragraph of Article 314-15 of the AMF General Regulation, of Article 27 of Directive 2006/73/EC implementing MiFID I, as follows:

Article 325-5 of the AMF General Regulation

All information, including advertisements, sent by a financial investment adviser shall be fair, clear and not misleading.

The content of information must comply with Articles 314-10 to 314-17.

Article 314-15 of the AMF General Regulation

Where the information contains information on future performance, the following conditions shall be satisfied:

1. The information must not be based on or refer to simulated past performance.

2. It must be based on reasonable assumptions supported by objective data.

3. Where the information is based on gross performance, the effect of commissions, fees or other charges must be disclosed.

4. The information must contain a prominent warning that such **forecasts** are not a reliable indicator of future performance.

These amendments to the AMF General Regulation will then be passed on to the minister with responsibility for the economy for approval by way of a ministerial order.

Furthermore, the AMF has agreed to publish a new policy document recommending that professionals (i) include a disclaimer addressed to investors and (ii) adopt best practice, taking into account feedback from the consultation, as follows:

Investor information on future performance simulators

Recommendation

To minimise the risk of misunderstanding, it is recommended that firms wishing to use a future performance simulation tool require the client to confirm that a ‘health warning’ message has been read before charts are displayed.

It is recommended that the message below be displayed legibly, on the same screen as the chart and in a box in clearly readable bold type.

The chart [or result] shown is not a forecast of the future performance of your investments. Its purpose is solely to illustrate the mechanics of your investment over the investment period.

The value of your investment could diverge from the results shown, upwards or downwards.

[*Where more than one scenario is shown (e.g. best case, worst case and neutral), the following should be added:*] Gains and losses can exceed the amounts shown in the best and worst case scenarios.

By remaining on this site, you confirm that you acknowledge this warning, understand it and accept its content.

For example, a message that can only be seen after scrolling down would not be considered compliant.
For face-to-face simulations, the standardised message could appear purely on the document containing the simulation, which is printed out and handed to the client by the adviser once the simulation has been run.

Technical aspects of designing future performance simulators

It seems that some future performance simulation tools are based on unrealistic assumptions that are liable to lead to the dissemination of potentially misleading and overly optimistic information.
Cases have been observed in which providers communicate on a highly unfavourable scenario for which an investment consisting of money market assets is illustrated using manifestly disproportionate annual performance data, while others use inappropriate short-term discount rates.

The AMF recommends that the following best practice be adopted:

- Performance simulations are based on realistic market assumptions;
- The volatility assumptions used in a future performance simulation chart are consistent with the underlying assets, the allocation and the investment period being simulated;
- A simulation takes account of the investment horizon and is based on reasonable market assumptions consistent with that horizon (interest rates, volatility, inflation, etc.) founded in objective factors;
- Long-term interest rate assumptions are not used to simulate future performance of fixed income investments over the short term.