Canadian Securities Administrators / Autorités canadiennes en valeurs mobilières

CSA Notice 81-324 and Request for Comment *Proposed CSA Mutual Fund Risk Classification Methodology for Use in Fund Facts*

December 12, 2013

Introduction

The Canadian Securities Administrators (the CSA or we) are publishing for a 90 day comment period a CSA risk classification methodology (the Proposed Methodology) for use by mutual fund managers in the Fund Facts document (Fund Facts).

The text of the Proposed Methodology is contained in Annex A of this notice and is available on the websites of members of the CSA.

The CSA developed the Proposed Methodology in response to stakeholder feedback that the CSA has received throughout the implementation of the point of sale disclosure framework for mutual funds (the Framework), notably that a standardized risk classification methodology proposed by the CSA would be more useful to investors, as it would provide a consistent and comparable basis for measuring the risk of different mutual funds.

We expect that the Proposed Methodology could be used in documents similar to the Fund Facts as we move forward with summary disclosure documents for other types of publicly offered investment funds, particularly exchange-traded funds (ETFs).

We are seeking feedback on using the Proposed Methodology in the Fund Facts, in particular, whether the CSA should (i) mandate the Proposed Methodology or (ii) adopt it only as guidance for investment fund managers.

Background

Staged Implementation of the Framework

On June 18, 2010, the CSA published CSA Staff Notice 81-319 *Status Report on the Implementation of Point of Sale Disclosure for Mutual Funds*, which outlined the CSA's decision to implement the Framework in three stages.

The Fund Facts is central to the Framework. It is in plain language, no more than two pages double-sided and highlights key information important to investors, including past performance, risks and the costs of investing in a mutual fund.

The first two stages of the Framework are now completed. Currently, mutual funds subject to National Instrument 81-101 *Mutual Fund Prospectus Disclosure* (NI 81-101) must produce and file a Fund Facts and make it available on the mutual fund's or the fund manager's website. The Fund Facts must also be delivered or sent to investors free of charge upon request. Beginning on

June 13, 2014, the Fund Facts will be required to be delivered instead of the prospectus to satisfy the prospectus delivery requirements under securities legislation.

The CSA is currently working on proposed requirements that would implement delivery of the Fund Facts at the point of sale for mutual funds. We are also proceeding with rule making and seeking legislative amendments, where necessary, to introduce a summary disclosure document for ETFs, similar to the Fund Facts, and the requirement to deliver the summary disclosure document within two days of an investor buying the ETF.

Throughout the development of the Framework, stakeholders commented on the lack of standardization in risk disclosure, and supported the development of a standardized risk classification methodology by the CSA that could to be applied by investment funds managers in assessing the mutual fund's risk on the scale prescribed in the Fund Facts. According to stakeholders, the lack of a standard methodology could result in an inconsistent evaluation of risk and make comparisons between mutual funds difficult. Based on this feedback, the CSA has developed the Proposed Methodology.

For further information on the staged approach to implementation of the Framework, and its progress, please refer to the CSA member websites.

Risk scale in the Fund Facts

Currently, the Fund Facts requires the fund manager of a mutual fund to provide a risk rating for the mutual fund based on a risk classification methodology chosen at the fund manager's discretion. The fund manager must then identify the mutual fund's risk level on the scale prescribed in the Fund Facts which is made up of five categories ranging from Low to High.

In response to stakeholder feedback, and informed by investor document testing of the Fund Facts, the CSA made a number of changes to the presentation of risk in the Fund Facts that will take effect on January 13, 2014. Specifically, recognizing that the majority of fund managers use volatility of past returns (Volatility Risk) in assessing the risk classification of their mutual funds, we have clarified the disclosure in the Fund Facts to state that the risk scale is meant to measure Volatility Risk. Volatility Risk is now explained in concise and understandable language in the Fund Facts and the risk-return linkage has also been highlighted (i.e., funds with higher Volatility Risk may have a greater chance of losing money and may have a greater chance of higher returns). The Fund Facts must also state that low risk mutual funds can still lose money. We also added disclosure in the Fund Facts to clearly indicate that the risk disclosure constitutes the manager's risk rating of the mutual fund.

You can find additional background information on the comments we have received relating to the risk scale in the Fund Facts, and the presentation of risk generally, on the CSA member websites.

Substance and Purpose of the Proposed Methodology

The Proposed Methodology would enable a fund to identify its risk level on the scale prescribed in the Fund Facts.

In addition to consistency, we think that the use of a standard methodology will enhance transparency in the market by enabling third parties to independently verify the risk rating disclosure of a mutual fund in the Fund Facts.

Steps to Constructing the Proposed Methodology

In considering the development of the Proposed Methodology, we reviewed the investment fund risk classification methodology developed by the Investment Funds Institute of Canada (IFIC) (IFIC Methodology) which is the predominant risk classification methodology used today by fund managers to disclose a mutual fund's risk classification for use in the Fund Facts.

We also undertook a review of how other global regulators including the Committee of European Securities Regulators (CESR)[1] have approached risk disclosure in their summary disclosure documents. CESR mandates the use of a methodology for measuring and disclosing risk (the CESR Methodology) in its summary disclosure documents. We compared and analyzed essential components of the IFIC and CESR methodologies and kept in our view the most effective components in mind as we developed the Proposed Methodology.

In order to inform our work on the Proposed Methodology, we undertook consultations with industry representatives, academics and investor advocates, among others, in Montreal and Toronto in Fall 2013.

The majority of stakeholders we spoke with supported the development of a standardized, mandatory risk classification methodology, and agreed with the use of standard deviation as the risk indicator. Stakeholders also generally noted that implementation of the Proposed Methodology could result in changes to the risk band classification for some funds. In particular, some queried whether such changes could affect suitability assessments conducted by dealers. These stakeholders remarked that we would need to work closely with the Self-Regulatory-Organizations and dealers when considering the implementation of the Proposed Methodology. Some industry participants pointed out that the fund managers should be allowed some discretion in order to override the quantitative calculation for risk classification purposes.

The consultations brought up some further reflections and led to additional questions in Annex B.

Although standard deviation[2] is used by both IFIC and CESR methodologies and seems to remain the most common risk indicator used by Canadian investment fund managers, we examined other risk indicators currently in use and those that could potentially be used to determine and measure risk. In total, 15 risk indicators were studied. They can typically be grouped into one of five categories: overall volatility risk measures, tail-related risk measures, relative volatility measures, risk adjusted return measures, and relative risk adjusted return measures. Following a thorough analysis of all these risk indicators, we have chosen standard deviation as the most suitable risk indicator for the Proposed Methodology.

[1] Now the European Securities and Markets Authority (ESMA).

[2] Standard deviation measures how returns vary over time from the average return. It is a measure of the volatility of investments returns i.e., how spread out the returns are from their average, *on average*.

Our reasons for choosing standard deviation are as follows:

- The risk scale in the Fund Facts is intended to measure Volatility Risk, and standard deviation is the most widely accepted measure of volatility;
- Its calculation methodology is well known and established;
- The calculation is simple and does not require sophisticated skills or software;
- It provides a consistent risk evaluation for a broad range of investment funds;
- It provides a relatively stable but still meaningful evaluation of risk when coupled with an appropriate historical period;
- It is already broadly used in the industry, and serves as the basis for the IFIC and CESR methodologies;
- It is available from third party data providers, thereby providing a simple and effective source of data for oversight purposes both by regulators and by market participants (including investors); and
- The implementation costs are expected to be minimal.

Overview of the Proposed Methodology

The Proposed Methodology features are:

<table>
<tr><td>Risk indicator:</td><td>10-year (annualized) standard deviation
Note: Calculated on a 10 year historical basis.</td></tr>
<tr><td>Data used:</td><td>Monthly total return calculated in accordance with Part 15 of National Instrument 81-102 Mutual Funds.
Note: The monthly total return of a reference index should be used as a proxy to impute missing return data of a fund that does not have a 10 year track record.</td></tr>
<tr><td>Risk categories and corresponding standard deviation bands:</td><td><table>
<tr><td>Low</td><td>0% - 2%</td></tr>
<tr><td>Low to medium</td><td>2% - 6%</td></tr>
<tr><td>Medium</td><td>6% - 12%</td></tr>
<tr><td>Medium to high</td><td>12% - 18%</td></tr>
<tr><td>High</td><td>18% - 28%</td></tr>
</table></td></tr>
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	Very high	≥ 28%
Frequency of the risk classification assessment:	Monthly *Note:* Two tests are needed to assess the risk classification: (1) Determine if the 10-year standard deviation calculated for the past month falls in a risk band that is at least two risk bands lower or higher than the risk band classification indicated in the most current Fund Facts. If yes, change the risk rating to the indicated band. (2) Determine if the 12 month average risk classification, calculated from the current and preceding 11 monthly risk classifications (rounded to the nearest integer) falls into a different risk band than its current risk disclosure in the most recent Fund Facts. If yes, change the risk rating to the average risk band.	

The Proposed Methodology does not allow for qualitative factors or investment fund managers' discretion to impact the risk ranking process.

Use of a Reference Index

We propose to allow a reference index as a proxy for mutual funds that do not have sufficient performance history.

We have indicated in the Proposed Methodology that the reference index should meet the following criteria:

- have returns highly correlated to the returns of the mutual fund;
- contain a high proportion of the securities represented in the mutual fund's portfolio with similar portfolio allocations; and
- have a historical systemic risk profile highly similar to the mutual fund.

If a reference index is to be used as a proxy in calculating standard deviation, the Proposed Methodology contemplates specific prospectus disclosure and recordkeeping requirements, including written policies and procedures that would provide for a monthly monitoring of the appropriateness of the reference index.

Five to six category scale

The Proposed Methodology also contemplates moving from the five category scale currently prescribed in the Fund Facts to six categories, ranging from Low to Very High. Generally, money market funds as well as short term fixed income funds will be categorized as Low whereas the Very High category will tend to capture precious metal equity funds and commodity focused funds.

Changes to the Risk Scale

We recognize that the use of this Proposed Methodology could result in changes to the risk band categorization for some mutual funds between Fund Facts renewal dates. Consequently, we propose that the investment fund manager monitor the mutual fund's risk classification on a monthly basis, inform investors of risk band changes if they occur within certain prescribed quantitative boundaries and criteria, and update the Fund Facts accordingly.

Alternatives considered

An alternative to the Proposed Methodology is to continue to allow the fund manager to identify the mutual fund's risk level based on the risk classification methodology chosen by the manager. As most mutual fund managers use some type of return volatility measure to determine a mutual fund's risk level, comparability of the presentation of risk in Fund Facts may be achieved, up to a certain extent, without the need to develop the Proposed Methodology. However, we know that not all fund managers use risk classification methodologies based on volatility or variability of returns, and that many of the risk classification methodologies currently in use, including the IFIC Methodology, allow for a considerable degree of judgment and subjectivity, making meaningful risk disclosure comparisons by investors of the mutual fund's risk level difficult.

Anticipated Costs and Benefits

We think that the development of a standard methodology, whether mandated or adopted as guidance, would benefit both investors and the capital markets by providing consistency and transparency of disclosure and improved comparability of investment fund products. We further think that the costs of complying with the Proposed Methodology will be minimal, since most fund managers already use some type of return volatility measure which incorporates either standard deviation, or a close alternative to standard deviation, in order to determine, in whole or in part, a mutual fund's risk level on the scale prescribed in the Fund Facts. We recognize that there may be added costs if the Proposed Methodology causes risk disclosure changes to be made between Fund Facts renewal dates. However, based on our analysis of the Canadian fund universe, we expect these types of changes to occur infrequently and only when there has been a material change in the fund's Volatility Risk.

Overall, we think the potential benefits of improved comparability of the Fund Facts for investors, as well as enhanced transparency to the market, are proportionate to the costs of complying with the Proposed Methodology.

We seek feedback on whether you agree or disagree with our perspective of the cost burden of compliance with the Proposed Methodology.

Request for Comments and Feedback

We would like your input on the Proposed Methodology. Specifically, whether the CSA should (i) mandate the Proposed Methodology or (ii) adopt the Proposed Methodology only as guidance for investment fund managers. We seek suggestions of other means of achieving the same objective other than by mandating the Proposed Methodology, or by adopting it as guidance.

We also seek specific feedback on whether the Proposed Methodology could be used in similar documents to Fund Facts for other types of publicly-offered investment funds, particularly ETFs.

We have raised specific questions for comment in text boxes like this throughout **Annex A** to this Notice (the Proposed Methodology). You can also find a list of these questions in **Annex B**. We also welcome your comments on other aspects of the Proposed Methodology, including our general approach and any changes we should consider.

We cannot keep submissions confidential because securities legislation in certain provinces requires publication of a summary of the written comments received during the comment period. All comments will be posted on the AMF website at www.lautorite.qc.ca and on the OSC website at www.osc.gov.ca.

Deadline for Comments

Please submit your comments in writing on or before March 12, 2014. If you are not sending your comments by email, please send a CD containing the submissions (in Microsoft Word format).

Where to Send Your Comments

Address your submission to all of the CSA as follows:

British Columbia Securities Commission
Alberta Securities Commission
Financial and Consumer Affairs Authority of Saskatchewan
Manitoba Securities Commission
Ontario Securities Commission
Autorité des marchés financiers
Financial and Consumer Services Commission (New Brunswick)
Superintendent of Securities, Department of Justice and Public Safety, Prince Edward Island
Nova Scotia Securities Commission
Securities Commission of Newfoundland and Labrador
Superintendent of Securities, Northwest Territories
Superintendent of Securities, Yukon
Superintendent of Securities, Nunavut

Deliver your comments **only** to the addresses below. Your comments will be distributed to the other participating CSA.

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Contents of Annexes

Annex A – Proposed CSA Risk Classification Methodology

Annex B – Issues for Comment

Questions

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