CSA/ACVM Canadian Securities Administrators | Autorités canadiennes en valeurs mobilières

CSA NOTICE AND REQUEST FOR COMMENT

CSA MUTUAL FUND RISK CLASSIFICATION METHODOLOGY FOR USE IN FUND FACTS AND ETF FACTS

PROPOSED AMENDMENTS TO NATIONAL INSTRUMENT 81-102 *INVESTMENT FUNDS* AND RELATED CONSEQUENTIAL AMENDMENTS

December 10, 2015

Introduction

The Canadian Securities Administrators (**CSA** or **we**) is publishing for a 90-day comment period proposed amendments (**Proposed Amendments**) to:

- National Instrument 81-102 *Investment Funds* (**NI 81-102**);
- National Instrument 81-101 *Mutual Fund Prospectus Disclosure*;
- Companion Policy 81-101CP to National Instrument 81-101 *Mutual Fund Prospectus Disclosure*;
- National Instrument 41-101 *General Prospectus Requirements;*[1] and
- Companion Policy 41-101CP to National Instrument 41-101 *General Prospectus Requirements.*[2]

The Proposed Amendments are part of Stage 3 of the CSA's implementation of the point of sale disclosure project (**POS Project**).

The Proposed Amendments mandate a CSA risk classification methodology (the **Proposed Methodology**) for use by the fund manager for the purpose of determining the investment risk level of conventional mutual funds and exchange-traded mutual funds (**ETFs**) (which are collectively referred to as **mutual funds**) for disclosure in the Fund Facts document (**Fund Facts**) as required under Form 81-101F3 *Contents of Fund Facts Document* and in the ETF Facts document (**ETF Facts**) as required under proposed Form 41-101F4 *Information Required in an*

[1] As published for comment on June 18, 2015 in "CSA Notice and Request for Comment: Mandating a Summary Disclosure Document for Exchange-Traded Mutual Funds and its Delivery – Proposed Amendments to National Instrument *41-101 General Prospectus Requirements* and to Companion Policy 41-101CP to National Instrument *to Regulation 41-101 General Prospectus Requirements* and Related Consequential Amendments."
[2] See footnote 1.

ETF Facts Document, respectively.[3]

Currently, the Fund Facts requires a conventional mutual fund to provide its investment risk level based on a risk classification methodology chosen at the fund manager's discretion. We think that a standardized risk classification methodology provides for greater transparency and consistency, which will allow investors to more readily compare the investment risk levels of different mutual funds.

The Proposed Methodology also requires the investment risk level of a conventional mutual fund or an ETF to be determined for each filing of the Fund Facts or ETF Facts, as applicable, and at least annually.

Implementation of this initiative is responsive to comments received throughout the course of the POS Project regarding the need to ensure greater consistency in terms of investment risk level disclosure for mutual funds.

The text of the Proposed Amendments follows this Notice and is available on the websites of members of the CSA.

Background

POS Project

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 POS Project in three stages.

Since July 2011, every conventional mutual fund has been required to prepare a Fund Facts for each class and series. Since June 2014, every dealer has been required to deliver the Fund Facts instead of the prospectus in connection with the purchase of mutual fund securities. Following the publication of final amendments to the POS Project for pre-sale delivery on December 11, 2014, dealers will be required to deliver the Fund Facts at or before the point of sale starting May 30, 2016.

As part of the final stage of the POS Project, two concurrent work streams are under way:

1. ETF summary disclosure document and a new delivery model: proposed amendments published for comment on June 18, 2015 would require the filing of an ETF Facts and delivery of the ETF Facts within two days of an investor purchasing securities of an ETF; and

2. CSA mutual fund risk classification methodology: the Proposed Amendments introduce the Proposed Methodology as a standardized risk classification methodology to be applied in determining the investment risk level of conventional mutual funds and ETFs, which are disclosed in the Fund Facts and the ETF Facts, respectively.

[3] See footnote 1.

CSA Mutual Fund Risk Classification Methodology

Currently, the Fund Facts requires the fund manager of a conventional 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 also identifies the mutual fund's investment risk level on the scale prescribed in the Fund Facts which is made up of five categories ranging from Low to High.

An earlier version of the Proposed Methodology was published on December 12, 2013 by the CSA in CSA Notice 81-324 and Request for Comment *Proposed CSA Mutual Fund Risk Classification Methodology for Use in Fund Facts* (the **2013 Proposal**). The 2013 Proposal was developed in response to stakeholder feedback that the CSA has received throughout the implementation of the point of sale disclosure framework for mutual funds, 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.

A summary of the key themes arising from the 2013 Proposal was published in CSA Staff Notice 81-325 *Status Report on Consultation under CSA Notice 81-324 and Request for Comment on Proposed CSA Mutual Fund Risk Classification Methodology for Use in Fund Facts* (**CSA Staff Notice 81-325**).

Substance and Purpose

By mandating the Fund Facts, and eventually the ETF Facts, we intend to provide investors with the opportunity to make more informed investment decisions, by giving investors access to key information about mutual funds, including the investment risk level, in language they can easily understand.

We think that the introduction of a standardized risk classification methodology will help provide investors with meaningful comparisons between conventional mutual funds and/or ETFs.

The 2013 Proposal

In developing the 2013 Proposal, we reviewed the investment fund risk classification methodology developed by the Investment Funds Institute of Canada (**IFIC**) (**IFIC Methodology**), which is widely used by fund managers in Canada to disclose a conventional mutual fund's investment risk level in the Fund Facts. We also reviewed how other global regulators approached risk disclosure in their summary disclosure documents. We examined the methodology of the Committee of European Securities Regulators (**CESR**)[4] for measuring and disclosing risk in its summary disclosure document, the Key Investor Information Document.

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

Although standard deviation[5] is used by both IFIC and CESR methodologies, we also examined other risk indicators currently in use and those that could potentially be used to determine and measure risk. We studied 15 indicators, including standard deviation, which 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.

After a thorough analysis of these 15 indicators, we chose standard deviation as the most suitable risk indicator for the following reasons:

- Its calculation is well known and established;
- The calculation is relatively simple and does not require any sophisticated skills or software;
- It provides a consistent risk evaluation for a broad range of mutual 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.

We consulted 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 sole risk indicator to determine a mutual fund's investment risk level on the Fund Facts' scale and proposed ETF Facts' scale. 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.

Feedback on the 2013 Proposal

We received 56 comment letters on the 2013 Proposal. Copies of the comment letters are posted on the website of Autorité des marchés financiers at www.lautorite.qc.ca and the website of the Ontario Securities Commission at www.osc.gov.on.ca. You can find the names of the commenters and a summary of the comments relating to the 2013 Proposal and our responses to those comments in Annex A to this Notice.

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

Generally, the majority of commenters supported the development of a standardized, mandatory risk classification methodology, and agreed with the use of standard deviation as the sole risk indicator to determine a mutual fund's investment risk level on the Fund Facts' scale.

Summary of Key Changes to the 2013 Proposal

The following is a summary of the key changes made to the 2013 Proposal.

- **Application of Proposed Methodology to ETFs – s. 15.1.1, NI 81-102**

  In addition to its application to conventional mutual funds, we extended the application of the Proposed Methodology to ETFs.

- **Investment Risk Level – Item 1 of Appendix F, NI 81-102**

  Instead of a six-category scale, we kept the CSA five-category scale currently prescribed in the Fund Facts and proposed ETF Facts. We also changed the standard deviation ranges proposed in the 2013 Proposal, which make them consistent with the standard deviation ranges in the IFIC Methodology.

  In addition, the investment risk level of a mutual fund may be increased if doing so is reasonable in the circumstances.

- **Mutual funds with less than 10 years of history - Item 4 of Appendix F, NI 81-102**

  In the 2013 Proposal, we had a list of criteria for an index to be considered acceptable as a reference index and a list of reference index principles. We removed the list of criteria, but we kept the list of reference index principles and amended it.

- **Fundamental Changes – Item 5 of Appendix F, NI 81-102**

  We added requirements to the Proposed Methodology on how to calculate the standard deviation where there has been a reorganisation or transfer of assets pursuant to paragraphs 5.1(1)(f), (g) or subparagraph (h)(i) of NI 81-102, or where there has been a change to the fundamental investment objectives of a mutual fund pursuant to paragraph 5.1(1)(c) of NI 81-102.

- **Frequency of determining the investment risk level of a mutual fund – s. 15.1.1, NI 81-102**

  We changed the frequency of determining the investment risk level of a mutual fund. Rather than monthly, the investment risk level must now be determined upon the filing of a Fund Facts or ETF Facts and, in any case, at least annually.

- **Records of standard deviation calculation**

We removed the requirement to maintain records for a ten-year period when using the Proposed Methodology to determine the investment risk level of a mutual fund. The requirement in securities legislation to maintain records for a period of 7 years from the date the record was created applies.[6]

Summary of the Proposed Amendments

Application

The Proposed Amendments apply to conventional mutual funds and ETFs.

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>Investment risk level and corresponding standard deviation ranges</td><td><table>
<tr><td>Low</td><td>0 to less than 6</td></tr>
<tr><td>Low to medium</td><td>6 to less than 11</td></tr>
<tr><td>Medium</td><td>11 to less than 16</td></tr>
<tr><td>Medium to high</td><td>16 to less than 20</td></tr>
<tr><td>High</td><td>20 or greater</td></tr>
</table>
Note: The investment risk level of a mutual fund may be increased if doing so is reasonable in the circumstances. Adequate records should be maintained to document this increase.</td></tr>
<tr><td>Frequency of determining the investment risk level of a mutual fund</td><td>(a) for each filing of a Fund Facts or ETF Facts; and

(b) at least annually.</td></tr>
</table>

Use of a Reference Index

We propose to allow a reference index as a proxy for conventional mutual funds and ETFs that do not have a sufficient 10-year performance history. We have indicated in the Proposed Methodology that the appropriate reference index should meet, among other things, the following principles:

[6] Section 11.6 of National Instrument 31-103 – *Registration Requirements, Exemptions and Ongoing Registrant Obligations*.

(a) is made up of one or a composite of several market indices that best reflect the returns and volatility of the mutual fund and the portfolio of the mutual fund;

(b) has returns highly correlated to the returns of the mutual fund;

(c) contains a high proportion of the securities represented in the mutual fund's portfolio with similar portfolio allocations;

(d) has a historical systemic risk profile highly similar to the mutual fund;

(e) reflects the market sectors in which the mutual fund is investing;

(f) has security allocations that represent invested position sizes on a similar pro rata basis to the mutual fund's total assets;

(g) is denominated, in or converted into, the same currency as the mutual fund's reported net asset value;

(h) has its returns computed on the same basis (e.g., total return, net of withholding taxes, etc.) as the mutual fund's returns;

(i) is based on an index or indices that are each administered by an organization that is not affiliated with the mutual fund, its manager, portfolio manager or principal distributor, unless the index is widely recognized and used; and

(j) is based on an index or indices that have each been adjusted by its index provider to include the reinvestment of all income and capital gains distributions in additional securities of the mutual fund.

If a reference index is to be used as a proxy, a mutual fund must disclose in the prospectus a brief description of the reference index, and if the reference index is changed, details of when and why the change was made.

The index or indices used in the management report of fund performance (MRFP) in Form 81-106F1 *Contents of Annual and Interim Management Report of Fund Performance* can also be used as a proxy to determine the investment risk level of the mutual fund, if the index or indices meet the principles set out in the Proposed Methodology.

Five-category scale

The Proposed Methodology contemplates keeping the CSA's five-category scale, ranging from Low to High, currently prescribed in the Fund Facts and proposed in the ETF Facts.[7] We note that the standard deviation ranges for the corresponding investment risk levels set out in the Proposed Methodology are consistent with the IFIC Methodology. This approach should minimize the changes in investment risk levels for mutual funds resulting from the

[7] See footnote 1.

implementation of the Proposed Methodology, which was a concern expressed by stakeholders.

Anticipated Costs and Benefits

The Proposed Methodology is responsive to comments we received throughout the course of the POS Project regarding the need for a standard risk classification methodology to be used in the Fund Facts. We think that the development of the Proposed Methodology would benefit both investors and the market participants by providing:

- a standard risk classification methodology across all conventional mutual funds for use in the Fund Facts and all ETFs for use in the proposed ETF Facts;[8]
- consistency and improved comparability between conventional mutual funds and/or ETFs; and
- enhance transparency by enabling third parties to independently verify the risk rating disclosure of a conventional mutual fund in the Fund Facts or an ETF in the ETF Facts.

We further think that the costs of complying with the Proposed Methodology will be minimal since most fund managers already use standard deviation to determine, in whole or in part, a conventional mutual fund's investment risk level on the scale prescribed in the Fund Facts. In addition, as risk disclosure changes in the Fund Facts or ETF Facts between renewal dates are expected to occur infrequently, the costs involved would be insignificant.

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

Transition

Subject to the rule approval process, we anticipate publishing final rules aimed at implementing the Proposed Amendments in the Fall of 2016 (**Publication Date**). We anticipate the Proposed Amendments will be proclaimed into force three months after the Publication Date (**In Force Date**). After the In Force Date, the investment risk level of conventional mutual funds and exchange-traded mutual funds must be determined by using the Proposed Methodology for each filing of a Fund Facts or ETF Facts, and at least annually.

Local Matters

Annex G to this Notice is being published in any local jurisdiction that is making related changes to local securities legislation, including local notices or other policy instruments in that jurisdiction. It also includes any additional information that is relevant to that jurisdiction only.

Some jurisdictions may require amendments to local securities legislation, in order to implement the Proposed Amendments. If statutory amendments are necessary in a jurisdiction, these changes will be initiated and published by the local provincial or territorial government.

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[8] See footnote 1.

Unpublished Materials

In developing the Proposed Amendments, we have not relied on any significant unpublished study, report or other written materials.

Request for Comments

We welcome your comments on the Proposed Amendments. To allow for sufficient review, we are providing you with 90 days to comment.

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.

Deadline for Comments

Please submit your comments in writing on or before March 9, 2016. If you are not sending your comments by e-mail, 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 Consumers Affairs Authority of Saskatchewan
The Manitoba Securities Commission
Ontario Securities Commission
Autorité des marchés financiers
Financial and Consumer Services Commission (New Brunswick)
Office of the Superintendent of Securities, Prince Edward Island
Nova Scotia Securities Commission
Office of the Superintendent of Securities, Newfoundland and Labrador
Office of the Superintendent of Securities, Northwest Territories
Office of the Yukon Superintendent of Securities
Office of the Superintendent of Securities, Nunavut

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

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Contents of Annexes

The text of the Amendments is contained in the following annexes to this Notice and is available on the websites of members of the CSA:

Annex A – Summary of Public Comments on the 2013 Proposal

Annex B – Proposed Amendments to National Instrument 81-102 *Investment Funds*

Annex C – Proposed Amendments to National Instrument 81-101 *Mutual Fund Prospectus Disclosure*

Annex D – Proposed Changes to Companion Policy 81-101CP to National Instrument 81-101 *Mutual Fund Prospectus Disclosure*

Annex E – Proposed Amendments to National Instrument 41-101 *General Prospectus Requirements*

Annex F – Proposed Changes to Companion Policy 41-101CP to National Instrument 41-101 *General Prospectus Requirements*

Annex G – Local Matters

Questions

Please refer your questions to any of the following:

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