CSA/ACVM Canadian Securities Administrators Autorités canadiennes en valeurs mobilières

CSA Staff Notice 81-338

Guidance on the Use of Discretion under the CSA Investment Risk Classification Methodology

April 16, 2025

1. Introduction

The purpose of this Canadian Securities Administrators (the **CSA** or **we**) Staff Notice (the **Notice**) is to provide guidance on the use of discretion under the CSA investment risk classification methodology (the **CSA Methodology**). The CSA Methodology is set out in Appendix F of National Instrument 81-102 *Investment Funds* (**NI 81-102**).

The guidance provided in this Notice is based on existing securities regulatory requirements and does not create any new legal requirements or modify existing ones. This Notice includes guidance that, while not required, CSA staff are of the view would support consistency in the use of discretion under the CSA Methodology.

We conducted continuous disclosure (**CD**) reviews of 45 investment fund managers (**IFMs**) to determine their use of discretion under the CSA Methodology. Over 60% of the IFMs subject to the CD review have used discretion to increase the investment risk levels of their funds (as defined below) determined by the standard deviation calculation under the CSA Methodology. Common reasons cited by IFMs for using discretion include maintaining the investment risk level to avoid unnecessary disruption and confusion to investors, having a fund that is on the cusp of two standard deviation ranges, having the same investment risk level as comparable funds and anticipating higher volatility. Notably, in 2019, some IFMs reportedly used discretion to maintain a fund's investment risk level as disclosed in the most recently filed Fund Facts document (**Fund Facts**) or ETF Facts document (**ETF Facts**) when the 10-year standard deviation calculation under the CSA Methodology no longer included the performance returns of the 2008 financial crisis. See "Continuous Disclosure Reviews" below.

We strongly encourage all IFMs to adopt policies and procedures to determine the circumstances in which it would be appropriate to use discretion to increase a fund's investment risk level under the CSA Methodology.

2. Background

Section 15.1.1 of NI 81-102 mandates the use of the CSA Methodology by IFMs to determine the investment risk level of conventional mutual funds, alternative mutual funds and exchange-

traded mutual funds (**ETFs**) that are reporting issuers (which are collectively referred to as **funds**) for use in the Fund Facts and in the ETF Facts, as applicable.

The CSA Methodology was implemented to benefit both investors and market participants by providing:

- a standardized risk classification methodology across all funds for use in the Fund Facts and the ETF Facts,
- consistency and improved comparability between funds, and
- enhanced transparency by enabling third parties to independently verify the risk rating disclosed in the Fund Facts or the ETF Facts.

Under the CSA Methodology, a fund must calculate its standard deviation for the most recent 10 years to determine its investment risk level on the 5-category risk scale in the Fund Facts or ETF Facts, as applicable:

Standard Deviation Range	Investment Risk Level
0 to less than 6	Low
6 to less than 11	Low to medium
11 to less than 16	Medium
16 to less than 20	Medium to high
20 or greater	High

For a fund with less than 10 years of history, the CSA Methodology requires that the fund use their available return history and impute the return history of an underlying fund, another mutual fund or a reference index, as applicable, for the remainder of the 10-year period to calculate the fund's standard deviation.

3. Use of Discretion

In addition to the standard deviation calculation, there may be circumstances where other quantitative or qualitative factors may be considered in determining the investment risk level of funds. The CSA Methodology does not allow an IFM to use discretion to classify a fund at a lower investment risk level than indicated by the standard deviation calculation. However, the CSA Methodology does allow the use of discretion by an IFM to classify a fund at a higher investment risk level than that indicated by the standard deviation calculation if it is reasonable to do so in the circumstances.

In determining whether to exercise discretion, IFMs should consider whether the standard deviation calculation applied under the CSA Methodology results in a lower risk level than the IFM's expected risk level for the fund. Such circumstances may occur when a fund employs

investment strategies that produce an atypical or non-normal distribution of performance results. IFMs may consider other factors or risk metrics in order to determine whether it would be appropriate to increase the fund's risk level to better reflect the features of the fund. It is important for IFMs to consider using discretion when there are unusual market conditions and market volatility fluctuations.

The CSA Methodology requires funds to keep and maintain records that document how the investment risk level of a fund was determined, and if the investment risk level of a fund was increased, why it was reasonable to do so in the circumstances.

4. Continuous Disclosure Reviews

(a) Scope and Purpose

The purpose of the CD reviews was to better understand whether discretion under the CSA Methodology was being used, and if so, the factors considered in determining the use of discretion, and the related policies and procedures.

The IFMs were selected based on criteria designed to reflect a fair representation of assets under management (**AUM**):

- 15 IFMs with AUM of more than $5 billion
- 15 IFMs with AUM of between $300 million to $5 billion
- 15 IFMs with AUM of less than $300 million.

The scope of the CD reviews included:

(i) ***Policies and procedures***: whether the IFM had policies and procedures in place to determine the circumstances under which it would be reasonable to use discretion under the CSA Methodology and what the policies and procedures included.

(ii) ***The use of discretion under the CSA Methodology***: whether the IFM used discretion under the CSA Methodology to increase the investment risk level of a fund for the period from January 2018 to May 2024, and the factors considered in determining the use of discretion.

(b) Findings

The findings of the CD reviews are summarized below.

(i) ***Policies and procedures***:

(A) 60% of the IFMs reviewed had policies and procedures in place to determine the circumstances under which it would be reasonable to use discretion under the CSA Methodology.

The policies and procedures of these IFMs included the following:

- qualitative factors to consider in determining whether to use discretion
- quantitative thresholds to identify temporary movements in volatility for which no discretion would be used
- conduct quality assurance by performing manual recalculations of standard deviation for a random sample of funds
- internal audit team to conduct a review of the investment risk level classification process
- monthly or quarterly reviews of the investment risk levels.

(B) Approximately 25% of the IFMs reviewed used discretion but did not have any policies and procedures related to the use of discretion under the CSA Methodology.

These IFMs provided the following reasons for not having any related policies and procedures:

- policies and procedures would be restrictive as the use of discretion is determined on a case-by-case basis
- policies and procedures are not required as the use of discretion is not mandatory under the CSA Methodology
- a list of qualitative factors is considered in determining whether to use discretion under the CSA Methodology
- there are plans to formalize related policies and procedures.

(C) Approximately 15% of the IFMs reviewed did not have any related policies and procedures and have not used discretion under the CSA Methodology.

These IFMs provided the following reasons for not having any related policies and procedures:

- the investment risk level determined under the CSA Methodology is appropriate
- the use of discretion under the CSA Methodology would be an exception.

(ii) ***The use of discretion under the CSA Methodology***: for the period from January 2018 to May 2024

(A) Over 64% of the IFMs reviewed used discretion under the CSA Methodology to increase the investment risk level of a fund.

(B) Some factors that IFMs considered when determining whether to use discretion under the CSA Methodology include:

- the risk factors associated with the fund's characteristics, e.g., investment objectives, investment strategies, use of leverage, short positions, underlying asset classes
- the fund's standard deviation calculation resulted in an investment risk level that is at the higher end of a risk band
- the reference index used for funds with less than 10 years of history resulted in a lower investment risk level than expected
- the fund's standard deviation calculation resulted in a lower investment risk level by more than one risk band
- the fund's investment risk level disclosed in the most recently filed Fund Facts or ETF Facts
- the investment risk levels of funds in the same Canadian Investment Funds Standards Committee category
- the fund's historical or expected long-term volatility
- financial market volatility, including the impact of the COVID-19 pandemic
- interest rate movement.

(C) Of the IFMs reviewed that used discretion:

- approximately 60% of the IFMs used discretion to increase a fund's investment risk level because the standard deviation calculation under the CSA Methodology placed the fund on the higher end of a risk band
- approximately 40% of the IFMs used discretion to increase a fund's investment risk level to be consistent with the investment risk level previously disclosed in the most recently filed Fund Facts or ETF Facts,

i.e., the standard deviation calculation under the CSA Methodology placed the fund on a lower risk level than previously disclosed

- over 20% of the IFMs used discretion to increase a fund's investment risk level to be consistent with comparable funds

- over 10% of the IFMs used discretion to increase a fund's investment risk level as higher volatility was anticipated.

(D) In 2019, when the 10-year standard deviation calculation under the CSA Methodology no longer included the performance returns of 2008 which captured the financial crisis, the IFMs reviewed reported an almost four-fold increase (compared to 2018) in the use of discretion to increase the investment risk level of a fund, including to maintain a fund's investment risk level as disclosed in the most recently filed Fund Facts or ETF Facts, in order to reflect their funds' expected long-term volatility.

5. Guidance

The classification of a fund's investment risk level is not limited to the standard deviation calculation under the CSA Methodology as IFMs are allowed to use discretion to classify a fund at a higher investment risk level. Consistent with an IFM's fiduciary duty to act in the best interest of a fund, IFMs should consider whether it is reasonable to exercise discretion in the circumstances. In particular, IFMs should consider the standard deviation calculation and determine whether the investment risk level is appropriate given the type of fund, the types of investment strategies used, the asset class, general market performance expectations and abnormal return periods.

Under section 11.1 of National Instrument 31-103 *Registration Requirements, Exemptions and Ongoing Registrant Obligations*, IFMs must establish, maintain and apply policies and procedures that establish a system of controls and supervision sufficient to provide reasonable assurance that the firm and each individual acting on its behalf complies with securities legislation, and to manage the risks associated with its business in accordance with prudent business practices. All IFMs are strongly encouraged to adopt policies and procedures regarding their risk classification methodology, including procedures to review the risk classification calculation and to determine the appropriateness of using discretion to increase a fund's investment risk level under the CSA Methodology.

IFMs are reminded of the importance of consistency in the use of discretion when determining the investment risk levels of their funds under the CSA Methodology. As funds are required to keep and maintain records of how investment risk levels are determined, policies and procedures can be referenced when documenting why it was reasonable to use discretion in the circumstances.

We will continue to monitor the use of discretion in determining the investment risk levels of funds under the CSA Methodology.

Questions

IFMs and their counsel are encouraged to use the guidance provided in this Notice.

Please refer your questions to any of the following:

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