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

January 29, 2015

Introduction

On December 12, 2013, the Canadian Securities Administrators (CSA or we) published CSA Notice 81-324 and Request for Comment *Proposed CSA Mutual Fund Risk Classification Methodology for Use in Fund Facts* (the Proposed Methodology) for a 90 day comment period (the Consultation).

The Proposed Methodology set out the framework and details of a methodology for the purpose of calculating and disclosing a fund's volatility risk on the risk scale included in the Fund Facts document (Fund Facts) as required under Form 81-101F3 *Contents of Fund Facts Document*.

Currently, the Fund Facts requires the manager of a mutual fund to provide a risk rating for the mutual fund based on a risk classification methodology chosen at the manager's discretion. One of the objectives of the Consultation was to seek feedback on the merits of introducing a standardized methodology to identify this risk rating. The CSA also sought feedback on using the Proposed Methodology for documents similar to the Fund Facts for other types of publicly offered investment funds, particularly exchange traded funds (ETFs).

This notice provides a summary of the key themes arising from the Proposed Methodology through the comment process and CSA next steps.

Background

The CSA developed the Proposed Methodology to address stakeholder feedback that we have received throughout the development of the point of sale disclosure framework for mutual funds. According to stakeholders, the lack of a standardized risk classification methodology results in inconsistent evaluations and disclosure of a mutual fund's risk rating in the Fund Facts, thereby making meaningful comparisons between different mutual funds difficult. The Proposed Methodology aims to enable a fund to identify its risk level on the Fund Facts' scale in a more consistent and transparent manner.

Key Themes from the Consultation

We received 56 comment letters on the Proposed Methodology. Copies of the comment letters are available on the Autorité des marchés financiers website at www.lautorite.qc.ca and on the Ontario Securities Commission website at www.osc.gov.on.ca.

The Proposed Methodology elicited feedback and comments from a broad cross-section of participants in the Canadian investment fund industry and from investors. We heard divergent views on many aspects of the Proposed Methodology. There was, however, almost unanimous support for a standardized methodology to assess a mutual fund's risk rating for disclosure in the Fund Facts so that investors can readily compare funds while providing a level-playing field for all mutual funds. We wish to thank all those who submitted a comment letter.

While many diverse opinions were submitted on elements of the Proposed Methodology, several key themes emerged from the comment letters. A very high level summary of these themes is set out below.

a. Use of Standard Deviation (SD) as the risk indicator

The Proposed Methodology uses SD as the indicator of risk. We had requested feedback regarding the appropriateness of SD as the risk indicator and, alternatively, recommendations for risk indicators other than SD that may be more suitable for the purposes of the Proposed Methodology.

The majority of commenters agreed with the use of SD as the risk indicator, and acknowledged that SD is also the predominant indicator currently in use by the industry. A few commenters, however, recommended using other measures such as Value at Risk (VaR) and Conditional Value at Risk (CVaR).

Other commenters felt that SD may not be easily understood by retail investors.

b. Monthly total returns

The Proposed Methodology suggests that the SD be calculated using the monthly total returns of the mutual fund.

Commenters were almost unanimous in agreeing that using the mutual fund's monthly returns is appropriate as monthly data is currently used to calculate SD in the investment fund industry.

c. 10 year history

The Proposed Methodology contemplates a 10-year performance return period to calculate the SD as it allows, in the CSA's view, for a reasonable balance between indicator stability and the availability of data. A 10-year performance return period will also prevent too many fluctuations in the risk rating.

Many commenters supported the use of a 10-year performance history as it tends to attenuate sudden changes in financial markets. Other commenters, however, suggested using shorter time periods to better reflect the fact that close to 80% of mutual funds have an average lifespan of only five to six years. We received comments stating that (approximately) 4% of ETFs have ten years of performance history. Some commenters also said that the average period for which an investor holds a mutual fund is less than seven years, with that period being substantially shorter for investors holding ETFs.

d. Fund series/class used

The Proposed Methodology uses the total return of the oldest fund series/class of the securities of each fund as the basis for the volatility risk calculation across all series/classes of that fund, unless an attribute of a particular series/class would result in a materially different level of volatility risk. In such instances, the total return of that particular fund series/class is used.

Commenters almost unanimously agreed with this proposal. Commenters noted that it is not necessary to apply the Proposed Methodology to individual series/class as they generally bear similar levels of volatility risk.

e. Use of reference index data

For funds that do not have 10 years of performance history, the Proposed Methodology contemplates funds using the returns of an appropriate reference index to impute the missing performance data that is required for the calculation of SD. The Proposed Methodology outlines criteria for the selection of the reference index.

Several commenters suggested that the reference index should be consistent with the broad-based market index chosen for the management report of fund performance[1].

On the other hand, a few commenters had concerns with the practice of fund managers selecting their own reference index as this practice might lead to a biased result.

A number of commenters also asked for additional clarification relating to the criteria outlined in the Proposed Methodology. For example, while the criteria require a reference index to have returns that correlate to fund returns, and stipulate that the reference index have a high proportion of the same securities as the fund, some commenters noted that the criteria may not be applicable to funds that pursue unique strategies.

Commenters also requested clarity on a range of topics such as the use of blended indices, disclosure requirements related to the reference index, and the definition of "widely recognized" in the context of reference index selection.

f. Six category risk scale in the Fund Facts

The Proposed Methodology contemplates changing the volatility risk scale in the Fund Facts from a five band to a six band risk scale. The CSA's intent with this proposal was to provide more meaningful risk categorization distinctions between fund types and asset classes. Although there was some support for using a six band risk scale, the majority of commenters opposed a change from five to six bands. Several commenters told us that the Proposed Methodology's risk bands would lead to a large number of funds being re-labeled with an apparent higher risk classification, without any associated change in the fund's risk. According to some of these commenters, between 70 to 80% of their funds would move upwards to a higher risk classification under the Proposed Methodology.

Many commenters expressed the concern that the creation of a sixth band would be an administrative burden that would result in increased costs for stakeholders as product

[1] See National Instrument 81-106 *Investment Fund Continuous Disclosure*, Part 4.

suitability would need to be reassessed on the same day for many investors. Some commenters suggested that the CSA adopt the Investment Fund Institute of Canada's risk classification methodology.

Other commenters noted that the impact of reclassification of funds into different risk categories is not a valid reason to not adopt the Proposed Methodology.

g. Monitoring and changing of risk categorizations

The Proposed Methodology sets out the calculation and process that must be followed by fund managers when monitoring changes in the risk band categories.

Many commenters told us that monthly monitoring is excessive and burdensome. Some of them recommended an annual monitoring process that is linked to a mutual fund's annual renewal or a material change to the business, operations or affairs of a mutual fund.

h. Records of SD calculation

The Proposed Methodology specifies that the calculation of a mutual fund's SD be adequately documented and that records be kept by the fund managers for at least 10 years.

The vast majority of commenters recommended that the CSA limit data retention to a 7 year period for consistency with paragraph 11.6 (1) (a) of National Instrument 31-103 *Registration Requirements, Exemptions and Ongoing Registrant Obligations*.

i. Discretion to override quantitative calculation of SD

The Proposed Methodology does not contemplate allowing fund managers any discretion for qualitative factors to override the result of the stipulated quantitative calculation of SD for assessing a mutual funds' risk rating. This was aligned with the CSA's stated intent of having a uniform and transparent application of the Proposed Methodology, for meaningful comparisons across investment funds.

Several commenters urged the CSA to revise the Proposed Methodology to allow for discretion in assessing a fund's risk rating, while some commenters opposed the use of discretion. Still others suggested allowing a fund manager to use its discretion solely to increase the risk rating of a fund.

j. Transition issues

The CSA invited comments on any transition issues that could arise as a result of the initial application of the Proposed Methodology.

Commenters urged the CSA to work with self-regulatory organizations in an effort to minimize the impact on investors as well as the costs and additional resources associated with the initial and future application of the Proposed Methodology. Other commenters encouraged the CSA to consider the next filing of annual renewal of regulatory documents as a window for implementation of a risk rating change.

Status and Next Steps

SD continues to be CSA staff's preferred risk indicator for the Proposed Methodology, and, based on the feedback received, most commenters appear to agree with that. We also continue to assess the potential impact on a large number of mutual funds being re-labeled within an apparently higher risk category as a result of the introduction of a six category scale in the Proposed Methodology.

The CSA is committed to being responsive to the feedback provided throughout the comment process. In this regard, the CSA will continue engaging with stakeholders and with self-regulatory organizations.

In 2015, we expect to publish for comment proposed rule amendments aimed at implementing a standardized risk classification methodology for use by mutual funds in their Fund Facts. A more detailed summary of comments received on the Proposed Methodology, with CSA responses, will also be published at that time.

Questions

Please refer your questions to any of the following CSA members:

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