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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

c/o

Me Anne-Marie Beaudoin
Corporate Secretary
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The Secretary
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VIA COURIER AND EMAIL

Dear Sirs/Mesdames:

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

On behalf of Advocis, The Financial Advisors Association of Canada, we are pleased to provide our comments in regards to the Canadian Securities Administrators' ("CSA") Notice and Request for Comments regarding its proposed mutual fund risk classification methodology for use in fund facts (the "Proposed Methodology").

About Advocis

Advocis is the largest and oldest professional membership association of financial advisors and planners in Canada. Through its predecessor associations, Advocis proudly continues over a century of uninterrupted history serving Canadian financial advisors and their clients. Our 11,000 members, organized in 40 chapters across the country, are licensed to sell life and health insurance, mutual funds and other securities, and are primarily owners and operators of

their own small businesses who create thousands of jobs across Canada. Advocis members provide comprehensive financial planning and investment advice, retirement and estate planning, risk management, employee benefit plans, disability coverage, long-term care and critical illness insurance to millions of Canadian households and businesses.

As a voluntary organization, Advocis is committed to professionalism among financial advisors. Advocis members adhere to an established professional Code of Conduct, uphold standards of best practice, participate in ongoing continuing education programs, maintain professional liability insurance, and put their clients' interests first. Across Canada, no organization's members spend more time working one-on-one on financial matters with individual Canadians than do ours. Advocis advisors are committed to educating clients about financial issues that are directly relevant to them, their families and their future.

Introductory Comments

Advocis supports the Proposed Methodology as it will improve Fund Facts. While we have been a cautious proponent of the Fund Facts initiative, we have stated that given the scope and complexity of the issues that bear upon investment decisions, distilling all of the information that a consumer needs to make an informed choice into two double-sided pages is ambitious. Without professional financial advice that analyzes each investment in the context of the consumer's particular financial situation, the superficial understanding garnered from Fund Facts may actually be harmful.

By its nature, Fund Facts is a summary document and consumers are inclined to use it as a tool to quickly compare different mutual funds. Doing this alone provides only the most cursory of analyses; nonetheless, that sliver of insight should be based on a standardized methodology so that consumers can benefit from an apples-to-apples comparison. Therefore, we support making the Proposed Methodology mandatory for use in Fund Facts, although we firmly believe that investors should not rely solely on summary information before making an investment decision.

Specific Comments

(i) Mandating the Proposed Methodology

We believe that the CSA should proceed with mandating the use of the Proposed Methodology. From the perspective of the consumer, the Proposed Methodology is of limited utility if it is not an enforced industry standard that drives the risk ratings in all Fund Facts, since consumers use the rating to compare alternative investing options. Further, much of the content of Fund Facts is prescribed in Form 81-101F3 to give consumers a consistent experience when browsing the Fund Facts of multiple products; since elements such as the presentation of best and worst return periods and the discussion of expenses are largely standardized, it is likely that most consumers would believe that the calculation and classification of risk is also already standardized, under the auspices of securities regulators.

If the Proposed Methodology were simply published as guidance, some fund managers would inevitably choose not to adopt it in favour of their own methodology. This would be misleading to consumers as they would not be likely to realize that some funds conform to the Proposed Methodology while others do not. It would also be to the detriment of fund managers who ascribe to the Proposed Methodology, as those that opt out could do so to avoid a higher risk label, putting their funds at a comparative advantage in a crowded marketplace.

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Therefore, on the basis of fairness to both consumers and industry, the CSA should make the Proposed Methodology mandatory as the basis of calculating risk in Fund Facts. Fund managers should generally not have discretion to modify an investment fund's risk rating, subject to one caveat: they should be permitted to select a risk rating that is more conservative (i.e. riskier) than what the Proposed Methodology computation would produce, based on justifiable but non-quantifiable additional risks, as discussed below.

(ii) Volatility risk does not provide the full picture to consumers

The Proposed Methodology should be based on standard deviation for the reasons outlined in the CSA's consultation paper, including its wide acceptance as a measure of volatility, its established calculation methodology, and its ability to be independently verified by third parties. If there is only one metric that is included to represent risk on a summary document such as Fund Facts, it should be volatility risk based on standard deviation, so to that extent, we support the Proposed Methodology.

However, as we have expressed in our previous submissions on the Point of Sale project, volatility risk is only one of the material risks that an investor should consider before making an investing decision. One of the risks that weigh heaviest on the minds of most consumers is the risk of losing their initial investment. But the returns of a mutual fund that loses 10% of its value each and every month would have a standard deviation of zero and would be classified as low risk under the Proposed Methodology, even though such an investment would lose nearly all of its value over the course of a year. We find it unlikely that most retail investors would consider such investments to be "low risk" propositions.

While this is an extreme example, the point we wish to convey is that standard deviation is not meaningful when viewed in isolation. It must be considered alongside the mean return of the investment during the associated period of time, and it is for that reason that mean and standard deviation of a dataset are traditionally reported together. Therefore, we suggest that the CSA add wording to this effect to the discussion of volatility, ensuring that consumers are mindful that looking at standard deviation alone is tantamount to seeing only half the picture.

Even if the mean return and standard deviation are clearly presented and brought to the consumer's attention, there are certain investment funds where past statistical information is not applicable to the fund's future risk profile. For example, target date funds or return of capital funds use investment strategies such as shifts in lifecycle asset allocation and cash flow smoothing which render any information gleaned from their historical standard deviation data irrelevant or misleading in the hands of consumers. Instead of looking at volatility for these types of investments, it is important that consumers understand the fund's strategy and attendant implications.

More generally, as the CSA states in its explanatory notes, a mutual fund may be subject to certain risks that are not reflected in the fund's historic volatility, either because the risky event has yet to occur or because it is difficult for the market to factor the impact of those events into the security's price. These risks include currency risk, concentration risk and counterparty risk, and they are not well-suited to be explained in Fund Facts' summary form. Due to these types of significant but unrealized risks, we recommend that fund managers retain the discretion to label their fund as riskier than what the Proposed Methodology's computation would otherwise indicate.

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So while we believe that the Proposed Methodology has merit and should be mandated in Fund Facts, doing so only incrementally improves the ability of consumers to appreciate the risk associated with a particular fund. Consumers that rely on Fund Facts alone, even after the document is enhanced by the Proposed Methodology, would still be deficient in the vital information they need before making an investment decision – with a possibility that they will be overly reliant on Fund Facts because they have heard that the CSA is somehow overseeing the evaluation of risk on it.

Consumers are best served when they access professional financial advice before making an investing decision. This provides a much better opportunity for consumers to understand the risks, both quantitative and qualitative, of a particular fund, and how that fund fits into the context of the consumer's larger financial plan. A professional financial advisor is able to explain complex financial concepts, including the variety of risks, in a meaningful way so that their clients can truly comprehend their options. We urge the CSA to mandate the inclusion of text to this effect at the end of the discussion of volatility risk; we would be pleased to work with the CSA in drafting this language.

(iii) Guidance re risk classification and suitability assessments

Contemporaneous with the CSA mandating use of the Proposed Methodology, we recommend that it issue accompanying guidance that makes clear that the risk classifications computed by the Proposed Methodology are but one factor to consider as part of an advisor's Know Your Product and Know Your Client suitability assessment obligations.

As discussed above, volatility risk does not capture all of the material risks that should impact a consumer's investing decision; we believe it would be incorrect for industry or consumers to use the Proposed Methodology's output as a proxy for a proper suitability assessment. For example, if based on a client's New Account Application Form or Know Your Client information, the client demonstrates a "medium to high" risk tolerance, this should not mean that any mutual fund which falls in the Proposed Methodology's 12-18% band is *de facto* suitable.

This is particularly the case as the fund is likely to make up just one part of a larger portfolio. Whether the overall portfolio risk is compliant with the client's stated risk tolerance must be viewed holistically, in the context of the consumer's financial plan. This includes a consideration of the risk represented by the other investments in the client's portfolio and in the context of the client's investment objectives, tax considerations and time horizon. For that particular client, a mix of higher risk and lower risk investments may be better suited, rather than simply filtering for those funds that the Proposed Methodology would classify as medium to high risk.

One major risk that consumers tend to overlook is diversification risk. For example, a consumer with a low risk tolerance may, based solely on their traditional risk rating in Fund Facts, select a variety of bond funds. This type of behaviour leaves the consumer particularly vulnerable to capital declines in a rising interest rate environment, and a consumer who does not understand the link between yield and price could feel that the low risk rating was misleading, harming their confidence in financial markets, fund manufacturers and securities regulators. Here, a better understanding of risk correlation and diversification would have resulted in superior outcomes for the consumer.

Therefore, we recommend that the CSA's accompanying guidance make clear that despite the improved risk classification brought about by the Proposed Methodology, that classification

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cannot be directly linked to the consumer's risk tolerance derived from his or her KYC and KYP suitability profile; overall compliance must be judged more holistically.

(iv) Time period considered

In the consultation paper, the CSA proposes that the time period to be used in the Proposed Methodology should be 10 years. We consider this period to be too long, and that seven years would be more appropriate.

According to an article published in *The Globe and Mail*, seven years represents the average length of time that a typical consumer holds a mutual fund,[1] so we believe that aligning the Proposed Methodology with this average would provide more useful information to consumers. Doing so would mean that Fund Facts more accurately provides insight on the experience a typical consumer would have had owning that mutual fund, without the need to make adjustments for the length of the holding period.

Reducing the relevant time period would also reduce the influence of the reference index, resulting in a truer calculation based on the mutual fund's actual data. The reality is that relatively few funds have 10 years of historical data. Funds that do not perform well are usually wound up before then, so those funds that do have a 10-year record tend to have performed relatively well.

According to the Proposed Methodology, funds lacking 10 years of data must supplement their dataset by using a reference index. While the consultation paper states that the reference index selected by the fund manager must satisfy certain criteria, such as having returns that are highly correlated to the returns of the fund at issue, it is likely that the reference index will exhibit survivorship bias and could inflate the risk performance of the fund at issue by smoothing out volatility.

Using any substitute to fill in gaps in data, such as a reference index, will detract from the veracity of the Proposed Methodology's output, with the effect being particularly significant for newer funds as they would require a greater proportion of substituted data. But the use of a reference index may be unavoidable if the goal is to use volatility as the basis of risk over a pre-determined period of time. We recognize that distilling any type of risk onto a summary document raises its own set of problems, as this is the inevitable result of condensing complex matters into such a form. But to minimize the distortion of the reference index, we suggest reducing the weight given to that proxy by changing the timeframe from 10 to seven years.

Additionally, as a housekeeping matter, seven years also aligns with many existing recordkeeping requirements throughout the industry. For example, both the Mutual Fund Dealers Association of Canada's Rule 5 and the CSA's National Instrument 31-103 speak to seven-year record retention timeframes. While perhaps not directly related to the retention of a mutual fund's monthly return data, we have always supported streamlining regulation where it makes sense. If seven years is already a widely-used industry standard, and using it here could actually enhance the operation of the Proposed Methodology, we believe the CSA should strongly consider doing so.

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[1] Hallet, Dan. "On mutual funds, and the leading myths." *The Globe and Mail* (3 August 1999). Online: http://www.theglobeandmail.com/globe-investor/investment-ideas/on-mutual-funds-and-the-leading-myths/article1201018/.

(v) Adjusting the risk bands

The Proposed Methodology includes six risk bands, whose boundaries were selected by the CSA on the basis of its review of about 2,200 fund datasets. While we appreciate the CSA's best efforts to carefully select the boundaries of the bands, and that such an exercise is never an exact science, we believe that the thresholds have been set somewhat too low; i.e., the proposed bands place funds that we believe should be in a lower risk category into a higher one.

Certain well-recognized and key industry benchmarks have standard deviations that would put them at a relatively high risk classification under the Proposed Methodology. For example, the annualized 10-year standard deviation of the DEX Bond Universe Index, a broad measure of the Canadian investment-grade fixed income market, is 3.3%. On this basis, the DEX would be rated low to medium risk, even though it is widely considered to represent some of the lowest risk investments: DEX is heavily-weighted to federal, provincial and municipal government and crown corporation bonds. We believe that DEX is a classic example of something that should be rated as low risk.

The S&P/TSX Composite Index, an index of the largest companies on the Toronto Stock Exchange by market capitalization, has an annualized 10-year standard deviation of 13.9%. This would put the Index in the medium to high risk classification according to the Proposed Methodology. Investing in equities certainly carries risk; but an index as broad as this, comprising about 70% of the market capitalization of all companies listed on the Toronto Stock Exchange, is well-diversified across many industry sectors. We believe that a rating of medium risk would be more appropriate.

Significantly, we believe that a rating invoking any "high risk" nomenclature would deter many from investing in that product – which could create the unintended consequence of causing consumers to avoid funds that track the S&P/TSX Composite Index in favour of lower risk products such as money market funds. Doing so would expose consumers to inflation risk and would harm their retirement planning in the accumulation phase. We believe that the CSA would agree that for most consumers, especially for those with longer-term planning horizons, there is a role for well-diversified equity investments in their portfolio, such as those represented by the S&P/TSX Composite Index.

More generally, the relatively high risk classifications generated by the Proposed Methodology could have the unintended consequence of causing a tremendous shift in assets across funds. In our experience, most consumers are quite risk adverse, and the reclassification of existing holdings as riskier under the Proposed Methodology, vis-à-vis the IFIC Methodology for example, could result in consumers liquidating those assets in favour of lower risk options, even if nothing has changed but the risk label on the fund. This premature selling could disrupt consumers' ability to fulfill their long-term financial plan and, in some cases, could result in consumers incurring early redemption penalties.

Therefore, we recommend that the CSA review the boundaries for each risk classification band, given that the Proposed Methodology as presented would place well-recognized benchmarks into higher risk classifications than many industry observers would believe appropriate.

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Conclusion

Advocis believes that mandating the Proposed Methodology will make Fund Facts a better document that will enhance its utility for consumers. By standardizing the information Fund Facts conveys, namely the riskiness of a mutual fund expressed as a function of its historical volatility, the CSA is enhancing the document in the way consumers use it most: as a comparison tool between different mutual funds.

While we laud the CSA for improving what Fund Facts does, it is just as important to be realistic about its limitations: it is not a mechanism for consumers to learn about and understand all of the material risks they need to know before making an investment decision. There are other major risks beyond volatility risk, such as counterparty risk and diversification risk, which are not necessarily expressed in the security's price. And the biggest risks for a particular consumer are a function of his or her personal goals and expectations in the context of an individual financial plan, and this can only be assessed by a qualified professional.

Therefore, we urge the CSA to ensure and promote a prominent role for professional financial advice. In the context of Fund Facts, this includes adding to the discussion about volatility risk a clear statement that the presentation of risk in Fund Facts is limited and recommending that consumers seek professional financial advice before making an investing decision.

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We look forward to working with the CSA as it develops the Proposed Methodology for implementation in Fund Facts. Should you have any questions, please do not hesitate to contact the undersigned, or Ed Skwarek, Vice President, Regulatory and Public Affairs at 416-342-9837 or eskwarek@advocis.ca.

Sincerely,

Greg Pollock, M.Ed., LL.M., C.Dir., CFP
President and CEO

Harley Lockhart, CLU, CH.F.C.
Chair, National Board of Directors