



FRANKLIN TEMPLETON
INVESTMENTS

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VIA EMAIL

March 12, 2014

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

Attention: The Secretary
Ontario Securities Commission
20 Queen Street West
22nd Floor, Box 55
Toronto, ON M5H 3S8

Me Anne-Marie Beaudoin
Corporate Secretary
Autorité des marchés financiers
800, square Victoria, 22^e étage
C.P. 246, tour de la Bourse
Montréal (Québec) H4Z 1G3

Dear Sir/Madame:

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

Franklin Templeton Investments Corp. ("FTI") welcomes the opportunity to make a submission with respect to the Canadian Securities Administrators ("CSA") Notice 81-324 and Request for Comment on the *Proposed CSA Mutual Fund Risk Classification Methodology for Use in Fund Facts* (the "Proposed Methodology").

FTI is a wholly owned subsidiary of Franklin Resources, Inc., a global investment organization operating as Franklin Templeton Investments. Through its subsidiaries, Franklin Templeton Investments provides global and domestic investment advisory services to the Franklin, Templeton, Franklin Bissett, Franklin Mutual Series, and Franklin Quotiential funds and institutional accounts. In Canada, FTI has more than 500 employees providing services to nearly 800,000 unitholder accounts and over 100 pension funds, foundations and other institutional investors.

FTI supports the CSA's attempt to create a standardized risk classification methodology in order to provide a consistent and comparable basis for measuring the risk of different mutual funds. However, we do have some concerns with the Proposed Methodology, which are set out below in the same order as the "Issues for Comment" in Annex B to the Proposed Methodology.

1. *As a threshold question, should the CSA proceed with (i) mandating the Proposed Methodology or (ii) adopting the Proposed Methodology only as guidance for fund managers to identify the mutual fund's risk level on the prescribed scale in the Fund Facts? Are there other means of achieving the same objective than by mandating the Proposed Methodology, or by adopting it only as guidance? We request feedback from investment fund managers and dealers on what a reasonable transition period would be for this.*

FTI believes that the CSA should mandate a standardized risk classification methodology as this would ensure uniformity in application amongst investment funds, which would make comparing mutual funds easier and more meaningful for investors.

FTI is supportive of a risk classification methodology that has the following elements:

1. a consistent calculation approach for all industry participants;
2. inclusion of other qualitative risk and return disclosure (for example, the discretion to highlight a specific fund risk like credit or liquidity risk); and
3. a focus on long term volatility behaviour.

In addition, as a global investment organization, FTI urges the CSA to consider adopting risk classification methodology and disclosure that is more consistent with the approach taken by regulators in other jurisdictions globally. While the Proposed Methodology follows a similar approach to the risk classification methodology promulgated by the Committee of European Securities Regulators ("CESR") (the predecessor to the European Securities and Markets Authority), used to calculate the Synthetic Risk and Reward Indicator for the Key Investor Information Document ("KIID") in Europe ("CESR Methodology"), it does so with different risk bands and calculation methodologies. FTI urges the CSA to consider the CESR Methodology.

A number of fund managers that offer funds in Canada also have funds registered in Europe that are offered globally, which already use the CESR Methodology in offering documents similar to the Fund Facts (specifically, the KIID). The time, resources and cost to build the processes necessary to implement a risk classification methodology are significant (see estimate for FTI below). Since these fund managers have already

developed the means to calculate the CESR Methodology, no further development effort would be necessary on their part.

If the CSA does adopt the Proposed Methodology, we recommend that the CSA provide for two transition periods: one for fund managers and one for dealers. We further recommend that each transition period be at least 12 months in duration.

By way of example, it took our affiliate approximately six months and significant resources (over \$100,000) to build the technological processes needed to implement the CESR Methodology in Europe. This does not include additional time and money needed to further automate and enhance those processes to ensure on-going compliance with the CESR Methodology. Because the Proposed Methodology uses different risk bands and calculation methodologies than the CESR Methodology, we expect that implementing the Proposed Methodology would require similar time, resource and financial expenditures.

From a dealer perspective, any risk classification methodology that changes the risk bands currently used in the Canadian investment fund industry can be expected to affect suitability assessments by dealers, which will likely require changes to the processes dealers use to evaluate and monitor the risk of their clients' investment portfolios. Such process changes could have a significant impact on dealer operations and therefore any implementation of the Proposed Methodology should provide dealers and self-regulatory organizations with a sufficient transition period to address these operational issues and communicate with investors.

- 2. We seek 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. For ETFs, what, if any, adjustments would we need to make to the Proposed Methodology? For instance should standard deviation be calculated with returns based on market price or net asset value per unit?*

As we believe that it is important to achieve consistent and comparable disclosure across all market participants offering products similar to mutual funds, we believe that a standard risk classification methodology should be applied to all types of publicly offered investment funds, including ETFs.

- 3. We seek feedback on whether you agree or disagree with our perspective of the benefits of having a standard methodology, as well as whether you agree or disagree with our perspective on the cost of implementing the Proposed Methodology.*

FTI agrees with the CSA's perspective on the benefits of having a standard risk classification methodology. However, we disagree with the CSA's assertion that "...the costs of complying with the Proposed Methodology will be minimal..." As noted in our response to question 1, when FTI implemented the CESR Methodology, it took significant time and resources in order to become fully compliant. While the CSA is proposing to apply a similar approach to the CESR Methodology, it is doing so with different risk bands and different calculation methodologies. Accordingly, implementation of the Proposed Methodology would require similar amounts of time and resources.

Due to the effects of risk band changes on client suitability assessments, we expect that the costs of implementing the Proposed Methodology would be significant for dealers as well.

4. *We do not currently propose to allow fund managers discretion to override the quantitative calculation for risk classification purposes. Do you agree with this approach? Should we allow discretion for fund managers to move their risk classification higher only?*

We agree that fund managers should not have the discretion to override the quantitative calculation for risk classification purposes. However, as set out in our response to question 5, we believe that fund managers should be given the discretion to include other qualitative risk disclosure in the Fund Facts in the interest of providing full, true and plain disclosure.

5. *Keeping the criteria outlined in the introduction above in mind, would you recommend other risk indicators? If yes, please explain and supplement your recommendations with data/analysis wherever possible.*

As mentioned in our response to question 4, FTI supports a risk classification methodology that focuses on long-term volatility behaviour, which would ensure comparability between different funds. However, we believe that fund managers, at their discretion, should also retain the flexibility to supplement the standard risk classification methodology with additional risk measures or language that may be more suitable to the strategy and risk profile of the specific fund and that might not be captured by a measure that relates only to return volatility. This might include highlighting credit risk, liquidity risk, counterparty risk, or operational risk, as is done in the KIID in Europe, or including additional risk measures such as duration or tracking error. The ability to highlight additional risks or to include additional risk measures would provide more fulsome disclosure, which would assist investors in making their investment decisions.

6. *We believe that standard deviation can be applied to a range of fund types (asset class exposures, fund structures, manager strategies, etc.). Keeping the criteria outlined in the introduction above in mind, would you recommend a different Volatility Risk measure for any specific fund products? Please supplement your recommendations with data/analysis wherever possible.*

FTI agrees that a risk classification methodology that is based on standard deviation of fund returns is a good measure of a fund's risk, but fund managers should have the flexibility to supplement standard deviation with other measures that may be more tailored to the specific fund. A good measure for a fixed income fund, for example, would be duration, which is a measure of sensitivity to interest rate risk. Another possible measure, for a fund that uses derivatives particularly, would be Value at Risk (VaR), which seeks to measure the possible downside risk at a given confidence level, i.e. the likely potential loss represented by the 1% worst outcome according to a model that the fund manager has tested against back history.

- 7. We understand that it is industry practice (for investment fund managers and third party data providers) to use monthly returns to calculate standard deviation. Keeping the criteria outlined in the introduction above in mind, would you suggest that an alternative frequency be used? Please specifically state how a different frequency would improve fund risk disclosure and be of benefit to investors. Please supplement your recommendations with data/analysis wherever possible.*

FTI agrees that using a fund's monthly returns to calculate standard deviation is appropriate.

- 8. Keeping the criteria outlined in the introduction above in mind, should we consider a different time period than the proposed 10 year period as the basis for risk rating disclosure? Please explain your reasoning and supplement your recommendations with data/analysis wherever possible.*

FTI believes that a five year period is sufficient as the basis for risk classification for several reasons. First, five years is the basis used by the CESR Methodology, which has emerged as the global standard for risk classification. Second, five years is generally sufficient to cover both up and down markets. Finally, many funds do not have 10 years of performance history, which would require the fund manager to use reference indices as a proxy for fund returns.

In our view, the use of reference indices to impute missing fund data is problematic except in the case of index funds or ETFs that seek to replicate a specific index. In these instances, the reference index would be representative of the fund's returns and therefore the particular fund's volatility risk. In all other cases, however, a reference index will not be truly representative of the style of the portfolio manager for a given fund.

If the Proposed Methodology uses a 10 year period, there will be a tendency for fund managers to have to use reference index returns, which would likely not be truly representative of the investment style of the fund, as a proxy for fund returns for a longer time period. Doing so would impair the usefulness of the risk classification as a reflection of the actual fund's volatility risk.

- 9. Keeping the criteria outlined in the introduction above in mind, should we consider an alternative approach to the calculation by series/class? Please supplement your recommendations with data/analysis wherever possible.*

FTI agrees that the total returns of the oldest fund series/class of securities of a fund be used as the basis for the fund's volatility risk calculation. In addition, with respect to corporate class funds that invest substantially all of their assets in units of one underlying mutual fund trust (the "Underlying Fund"), we urge the CSA to consider allowing fund managers to use the total returns of the oldest fund series of the Underlying Fund as the basis for calculating the corporate class fund's volatility risk, unless an attribute of the corporate class fund, such as currency hedging, would result in a materially different level of volatility risk. In such cases, the total returns of the oldest series of the corporate class fund would be used. Such an approach is permitted in the CESR Methodology.

Because corporate class funds are often several years younger than their Underlying Funds, under the Proposed Methodology their volatility risk calculations would be inconsistent despite the fact they are invested, directly or indirectly, in the same pool of assets. Allowing a corporate class fund to use its Underlying Fund's volatility risk calculation would be preferable to the corporate class fund using returns of a reference index to impute missing data as it would be more meaningful to investors.

10. Keeping the criteria outlined in the introduction above in mind, do you agree with the criteria we have proposed for the use of a reference index for funds that do not have sufficient historical performance data? Are there any other factors we should take into account when selecting a reference index? Please supplement your recommendations with data/analysis wherever possible.

In our view, as set out in our response to question 8, the use of reference indices to impute missing fund data is problematic except in certain limited cases, which is a principal reason that FTI favours a five year period as the basis for risk classification disclosure.

However, where a reference index must be used, FTI agrees with most of the reference index selection guidelines outlined in the Proposed Methodology. We note that others will likely prove especially problematic to apply. For example, for new funds, it will be difficult to select a reference index that: (1) is highly correlated to the returns of the fund; (2) contains a high proportion of the securities represented in the fund's portfolio with similar portfolio allocations; and (3) has a historical systematic risk profile similar to the fund.

11. Keeping the criteria outlined in the introduction above in mind,

- i. Do you agree with the proposed number of risk bands, the risk band break-points, and nomenclature used for risk band categories?*
- ii. Do the proposed break points allow for sufficient distinction between funds with varying asset class exposures/risk factors?*

If not, please propose an alternative, and indicate why your proposal would be more meaningful to investors. Please supplement your recommendations with data/analysis wherever possible.

The risk bands set out in the Proposed Methodology differ to a material degree with the risk bands incorporated in the CESR Methodology, making comparisons with funds globally more difficult. The Proposed Methodology uses six categories, with the lowest ones not finely tuned for very low risk funds like money market funds, compared to the CESR Methodology, which has a very low category for standard deviations of less than 0.5%, then two additional bands covering 0.5% to 2.0% and 2.0% to 5.0%. The Proposed Methodology only has 0 to 2% and 2% to 6%. FTI believes that there should be a distinction between funds that claim to offer full principal stability, such as money market funds and those that offer high but not complete principal stability. All the other breakpoints also differ between the Proposed Methodology and the CESR Methodology.

We believe there would be a benefit to adopting the same seven band scheme as the CESR Methodology.

12. *Do you agree with the proposed process for monitoring risk ratings? Keeping the criteria outlined in the introduction above in mind, would you propose a different set of parameters or different frequency for monitoring risk rating changes? If yes, please explain your reasoning. Please supplement your recommendations with data/analysis wherever possible.*

FTI believes that a risk classification methodology should provide a means to ensure that short-term fluctuations in fund risk ratings are minimized. The Proposed Methodology seeks to avoid such short-term fluctuations by providing two tests associated with the monthly calculation. However, we find these tests to be a bit confusing and potentially contradictory. The CESR Methodology includes a monthly calculation, and also provides a buffering approach that minimizes short-term fluctuations by requiring that risk ratings be calculated on a rolling 17 week or 4 month basis, with no change in the risk rating unless all 17 weeks or 4 months validate that a change is necessary. We believe that the CESR Methodology for buffering short-term fluctuations is more intuitive, with less potential to provide contradictory signals. In our experience, the CESR Methodology for buffering short-term fluctuations has also proven to be quite effective in maintaining fund risk rating stability.

If risk classification changes end up being a frequent occurrence, filing press releases, material change reports and amended fund facts will likely become a costly and disruptive exercise. In addition, we believe that it will require longer than 10 days after month end to make the necessary changes and to obtain the necessary approvals required to amend the fund facts.

13. *Is a 10 year record retention period too long? If yes, what period would you suggest instead and why?*

To the extent possible, FTI believes that record retention requirements under securities law should be as consistent as possible. Under section 11.6 of National Instrument 31-103 *Registration Requirements, Exemptions and Ongoing Registrant Obligations*, a registered firm is obligated to retain records for seven years from the date the record is created. Accordingly, we believe that the record retention period under the Proposed Methodology should be seven years.

14. *Please comment on any transition issues that you think might arise as a result of risk classification changes that are likely to occur upon the initial application of the Proposed Methodology. How would fund managers and dealers propose to minimize the impact of these issues?*

As set out above, we believe that there will be significant dealer and investor impact caused by any changes to the risk bands currently used in the investment fund industry. We believe that fund managers and dealers have little ability to minimize the impact of these issues. Accordingly, we suggest transition periods of at least 12 months for fund managers and dealers.

Thank you for your consideration of this submission. Please feel free to contact me at 416.957.6010 or my colleague, Ariane Farrell, at 416.957.6089 should you have any questions or wish to discuss our submission.

Yours truly,

FRANKLIN TEMPLETON INVESTMENTS CORP.



Brad Beuttenmiller
Senior Associate General Counsel