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## **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 41-101 General Prospectus Requirements**

## **and Related Consequential Amendments**

The Investor Advisory Panel is pleased to comment on this consultation regarding delivery of ETF Facts to investors and supports the CSA as it continues to encourage clear and comprehensive disclosure of investment products. The Panel is an independent body formed by the Ontario Securities Commission (OSC) in August 2010. We are charged with providing input on the Commission's policy initiatives, including proposed rules and policies, the annual Statement of Priorities, concept papers and specific issues. Our mandate is to represent the views of investors.

To that end, the Panel would like to make the following comments and suggestions for improvement based on the draft ETF Facts document submitted for consultation.

### **General Comments**

The Panel is pleased that the CSA has taken this initiative to improve transparency and educate investors about the risks and costs of ETFs. To that end, we support the delivery of an ETF Facts document and believe it is especially important given the growing popularity of ETFs in Canada (as of June 30, 2015, there were 367 ETFs in Canada with assets totaling US\$68 billion. *Source: ETFGI*)

While we offer specific comments related to the document below, the Panel has some general observations and suggestions:

**ETF definitions** - The difference in construction between ETFs and mutual funds can have an impact on both the costs and the risks. The CSA ought to consider creating a broader ETF education program to accompany the launch of ETF Facts that outlines the construction process and the key risks. The CSA should also ensure that it uses a consistent definition of ETFs throughout - we note three different definitions in the consultation document (below).

**ETF Delivery** - We recommend that, for retail investors, ETF Facts be delivered before the purchase. For on line trades, clicking on a link/ read/ agree would be acceptable. The delivery does not need to be made on subsequent purchases unless the ETF Facts has changed in the intervening period.

**Investment risk classification methodology** - The CSA should have its risk classification methodology firmly in place before mandating a risk rating disclosure as per the proposed regulation. Using subjective methods as a substitute or interim methodology can create confusion and (worse) could be misleading. If the CSA has not finalized the prescribed methodology at the time of implementing the ETF Facts, we recommend that the risk rating disclosure requirement be postponed and added at a later date.

**The risks of ETFs** - The ETF Fact sheet must be flexible enough to reflect the many ways in which ETFs are constructed and how the underlying asset classes can deliver what they promise (i.e. daily liquidity). Specific risks such as liquidity and tracking error are also quite specific to these products -- these should be reflected. At the same time, as the ETF space evolves and new products emerge, the ETF Fact sheet must evolve along with it. This is occurring in other jurisdictions -- the Hong Kong Stock Exchange and Securities and Futures Commission recently introduced new measures to raise awareness of synthetic ETFs. We recommend that the CSA seriously consider this model for implementation in Canada.

**Background research:** Although not part of the formal consultation request, the Panel would like to express concerns about the disconnect between the Fund Facts draft and observations made during the CSA's focus group-based research. In particular, the research revealed that a relatively high percentage of participants did not understand that a particular product was risky, or how to interpret the Fund Fact document. While we recognize the importance of using the same format and disclosure language that is used to describe mutual funds, we are of the view that more should be done to ensure the disclosure actually protects investors from making bad decisions.

### **ETF Facts Document**

Specific comments on the document:

*Information on Trading* - The Panel notes that information on daily volume is useful for evaluating the risk of an ETF, especially as it relates to liquidity. The explanation of the difference between market price and net asset value (NAV) included here is helpful, however, members of the panel wonder if this information could be conveyed in a more meaningful way?

*Shares traded* - Should market price range include odd lots and should days on which trading is under a certain number of trades be excluded? Also, rather than imposing a threshold on the number of shares traded (or odd lots), it may be more useful to add a warning that liquidity may be an issue for those ETFs that don't trade every day. All trading information should be included.

*Investment objective* - It would be helpful to include an explanation of how the choice of securities and derivatives is made (i.e. Criteria used for choosing specific bonds over others).

*Clarify the difference between distribution frequency and timing.* Right now this is not clearly laid out. If it is monthly, then there is no need to list the months. For income planning purposes, it may be useful to include the date of the distribution (i.e. the 15th of every month). And it may be that only one line "distribution" is required: e.g., monthly on the 15th, or quarterly on the 15th of March, June, September and December).

*Total Fund Expenses* - It might be more helpful to list this under “Fund Details” rather than MER.

*Return calculation* - These should be based on market value at the close not NAV. If both are shown, consider using market value as the main source of information.

*CUSIP* not useful for individual investors.

*DRIP* - The Panel notes individual investors might not be familiar with the term and what it means. Consider clarifying and add “Eligible” (see below).

*Form of distribution* - This should be highlighted particularly when it does not involve cash.

*Risk* - Market risk is not the only risk that investors should be aware of. The Panel recommends the CSA consider additional ETF-specific risks including:

- **Tracking error** - The price of the ETF units or shares can vary from the market value of the underlying shares (NAV) due to market supply and demand.
- **Leverage** - Leveraged ETFs and ETFs that employ derivatives have additional risks that should be clearly explained to investors who ought to understand how these products are constructed.
- **Liquidity risk** - ETFs based on thinly traded or niche markets could raise the risk of a liquidity mismatch between the ETF and the underlying investments. How does the ETF provider maintain liquidity for ETFs in such cases (i.e. for fixed income)?
- **Benchmarks** - Some ETFs (i.e., active ETFs) are not designed to track and index so there is no benchmark for performance over time.
- **Counterparty Risk** - Given how ETFs are constructed, what role does counterparty risk play in a given ETF?
- **Currency risk** - Are investors at risk of currency fluctuations?

Trailer Commissions – Only mention trailer commissions if they apply to the ETF and do not mention if there are none.

### **Comments on format and look of ETF Facts**

*Fonts* - The Panel recommends using a 12 pt or larger font to make the document more readable.

*Format, headings, methodologies, etc.* -- The Panel recommends that the formatting of ETF Facts should be as close to the MF Facts as possible for consistency and to facilitate comparisons by investors.

*Dates* - In the template on page 1, 3<sup>rd</sup> box, there is a list of Market price, NAV, Avg bid-ask spread, average premium/discount to NAV. This box should indicate the “as of date”. All data and performance references should show the applicable dates/periods. Dates throughout the template should be consistent.

### **Defining ETFs**

The Panel notes some inconsistencies in how ETFs are defined in the document that could impact investors’ understanding how the product works well as risks and costs.

Specific comments:

#### 14. 20 Part I- Information about the ETF Item 1 – Introduction

*Begin by explaining the difference between an ETF and a mutual fund* - The Panel recommends including a definition of ETFs, including how they are created and how they differ from mutual funds. ETFs and mutual funds are not created the same way - this could lead to additional considerations and/or risks for investors. When investing in mutual funds, for example, investors’ money is used to directly purchase securities and issue additional shares of the fund. In the case of ETFs, they are formed through creation units - ETF shares represent a fraction of each unit. Some types of ETFs also use derivatives to amplify performance (i.e., leveraged ETFs; conventional mutual funds are prohibited from doing so).

*Definitions - “Exchange-traded mutual fund” etc.* - In all, we note three different definitions of that an ETF is in the same document:

- *Annex C - 2. “ETF” means an exchange-traded mutual fund”*
- *5.(b) PART 3C 3C.2(4) [next page] “In Ontario, a security of an ETF is an investment fund security prescribed for the purposes of Subsections, etc.  
”*
- *13. (a) “For an investment fund in continuous distribution, state, etc.”*

The inconsistency is confusing. The panel recommends this definition be revisited based on global best practices (exchange traded funds or exchange traded products) and that the same term is used consistently throughout.

### **Investment Risk Classification Methodology**

The Panel recommends the risk classification methodology the CSA is working on be prescribed at the time of implementation of the ETF Regulation for consistency, objectivity, comparability, and for efficiency (also keeping in mind costs for providers). Should the CSA not have finalized the risk rating methodology at the time of implementing the ETF Facts regulation, the Panel strongly recommends that mandating disclosure of a risk rating in the ETF Facts be postponed and added when the methodology has been finalized.

The Panel does not recommend using a subjective measure at any point. Moreover, Staff should anticipate that the risk categories may be used in the algorithms for (Model) Portfolio construction by robo-advisors and by dealers and planners. The risk classification methodology should also be same for both mutual funds and ETFs.

### **Additional observations**

*14.20. Part I, Item 2 – Quick Facts – INSTRUCTIONS (7)* - The current sample template reads: “Dividend Reinvestment Plan (DRIP. For clarity, this should read: “Dividend Reinvestment Plan (DRIP) Eligible.”

*14.20. Part I, Item 3 – Investments of the ETF* - Include information about leverage and the leverage ratio, where applicable.

*14.20. Part I, Item 5 – Guarantee* - Should address insurance provided by derivative strategies and how it is applied.

*14.20. Part II – Costs, Rights and Other Information – Item 1 -1.3 (2)* -- In the block in the sentence: “This is the total of the ETF’s Management fee and operating expenses” we suggest replacing “total” by “sum”. At the bottom of the block we suggest adding “Total” in front of “ETF expenses”.

### **Right for Withdrawal of Purchase**

The Panel notes that if the two-day withdrawal period is triggered by the receipt of the trade confirmation rather than the prospectus it would apply to all trades.