

Sent Via email

August 2, 2015

Kenmar Comment Letter

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
http://www.osc.gov.on.ca/en/SecuritiesLaw_csa_20150618_41-101_rfc-amd-general-prospectus.htm

The Secretary
Ontario Securities Commission
20 Queen Street West
22nd Floor
Toronto, Ontario M5H 3S8
Fax: 416-593-2318
comments@osc.gov.on.ca

M^e Anne-Marie Beaudoin
Corporate Secretary
Autorité des marchés financiers
800, square Victoria, 22e étage
C.P. 246, tour de la Bourse
Montréal (Québec) H4Z 1G3
Fax : 514-864-6381
consultation-en-cours@lautorite.qc.ca

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)
Office of the Superintendent of Securities, Prince Edward Island
Nova Scotia Securities Commission
Office of the Superintendent of Securities, Newfoundland and Labrador

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Investor Education and Protection

Office of the Superintendent of Securities, Northwest Territories
Office of the Yukon Superintendent of Securities
Office of the Superintendent of Securities, Nunavut

Kenmar Associates is an Ontario- based privately-funded organization focused on investment fund investor education via on-line research papers hosted at www.canadianfundwatch.com . Kenmar also publishes **the Fund OBSERVER** on a bi-weekly basis discussing investor protection issues primarily for investment fund investors. An affiliate, Kenmar Portfolio Analytics, assists, on a no-charge basis, abused investors and/or their counsel in filing investor complaints and restitution claims.

We are pleased to offer our comments on this important consultation.

We agree with the already posted comments provided by Mr. L. Elford and the Small Investor Protection Association.

The CSA initiative of utilizing ETF Facts is a positive step in encouraging retail investors to consider Exchange Traded Funds (ETF's) for their portfolios. Given prevailing low interest rates, a greater use of ETF's increases the chances for Canadians in growing their savings. Providing a plain language disclosure will be a positive factor in drawing investors' attention to ETF's (we assume this excludes Closed-end Funds)..

The ETF Facts provide for some additional ETF-specific information that isn't included in the Fund Facts form or the current ETF summary documents. Most of these additional requirements are intended to highlight that ETFs, unlike conventional mutual funds, are traded on an exchange. For example, the CSA propose the inclusion of additional disclosure on ETF pricing information over a 12 month period ending within 60 days of the date of the ETF Facts, such as the market price, net asset value (**NAV**), average bid-ask spread and average premium/discount to NAV. Prescribed disclosure on the significance of the difference between the market price and the NAV and a description on the impact of premium/discount of market price to NAV will also be required. It will be interesting to see the comments the CSA receive on this requirement, as it is not clear to us whether this information will be meaningful or useful to retail investors. Other ETF specific content includes average daily volume and number of days traded over a 12 month period, which should, at least in principle, provide investors with information about the liquidity of their investment.

One thing that we want to relate to you is that we have heard from a number of fund industry participants on plain language. They tell us they do a lot of studies on what different words mean to investors and what they do and do not understand. Interestingly, they have found that investors really do not understand the term "liquidity". In light of that, we are surprised ETF Facts uses that term as part of the ETF Facts explanations. If the focus groups are saying that "liquidity" is understood, the industry think it shows that the sample sizes are ineffective,It is food for thought we felt should be brought to your attention.

We assume that ETF Facts will only be required of Canadian-domiciled ETF manufacturers and that copies of the Summary Prospectus will be provided for U.S. originated ETF's. Per CETFA, approximately 20% of ETF assets held by Canadians are non-Canadian listed ETFs. Approximately 1/3 of all ETFs (US-based and Canadian-based) are held by investors other than the retail market.

The new simplified ETF disclosure regime should also be accompanied by a meaningful CSA sponsored investor education initiative. The brochure should include a dictionary. The brochure would be used to explain in plain language how to use ETF Facts for decision making. The Vanguard Canada ETF education centre is a good model for ETF investor education.

<https://www.vanguardcanada.ca/individual/insights/etfeducation.htm#/> See also a Bulletin (in REFERENCES) from the Hong Kong Securities Agency. We believe such a brochure is a critical success factor for the ETF Facts disclosure regime.

We would like to expand on a few points made by Elford and SIPA.

#1 Pre-sale delivery of ETF Facts Under the proposed rule amendments dealers will be required to deliver the applicable ETF Facts document to investors within two days of any trade in an ETF. We feel that pre-sale delivery is essential if investors are to make informed investment decisions. As noted in the document testing research / focus groups, pre-sale delivery is desired by a vast majority (87 %) of retail investors Ref *CSA Point of Sale Disclosure Project: ETF Facts Document Testing,*"

<http://www.osc.gov.on.ca/documents/en/InvestmentFunds/etf-facts-document-testing.pdf> . In the case of online purchases we would agree that providing an intelligent confirmation process of having accessed/read/confirm the online file before clicking BUY would constitute delivery. We note too that MFDA licensed mutual fund salespersons will soon be able to sell selected ETF's; it is necessary that ETF's be delivered in the same manner as mutual funds to avoid investor and dealer Rep confusion and to treat both products in the same manner. We also question whether this has the potential to be operationally complicated for dealers who distribute both mutual funds and ETFs.

#2 Return calculations ETF Performance returns should be based on market value - This is particularly true for actively- managed and currency-hedged ETF's. In any event, the ETF Facts disclosure should be harmonized with CRM2 performance reporting disclosure so investors are not confused.

3 Risk disclosure We agree with SIPA- the risk disclosure system rooted in the standard deviation (SD) is flawed . We do not agree that the use of a SD based, word descriptor for risk is proper or adequate. In fact, we believe it is misleading and hence breaks the cardinal rule of any disclosure- DO NO HARM . See the Kenmar Comment letter on mutual fund risk for comprehensive backup for our rationale. Another good reference here is **Product risk disclosure needs improvement**

<http://www.financialobserver.com.au/articles/product-risk-disclosure-needs-improvement>

A recent article *Investors Need More Meaningful Risk Measures* by respected fund analyst Dan Hallet had this to say:

“ I tracked risk rating changes on 44 mutual funds since last October. The table below lists the affected 28 unique funds – excluding 16 funds that are simply other incarnations of the 28 – and summarizes the risk rating changes and related risk statistics.

Fund Name	Direction	Previous Risk Rating	New Risk Rating	Risk Rating Method	Biggest Drop in Value	Time Under Water
Franklin Bissett Canadian Balanced	⬇️	Low-to-Medium	Low		-28%	2 years & 4 mos
Franklin Bissett Canadian All Cap Bal	⬇️	Low-to-Medium	Low			
Franklin Bissett Canadian High Dividend	⬆️	Low-to-Medium	Medium		-35%	1 year & 9 mos
Franklin Bissett Dividend Income	⬇️	Low-to-Medium	Low		-25%	1 year & 10 mos
Franklin Quotential Balanced Income	⬇️	Low-to-Medium	Low	Historical Volatility	-23%	2 years & 5 mos
Franklin Quotential Diversified Equity	⬇️	Medium	Low-to-Medium		-44%	5 years & 7 mos
Franklin World Growth	⬇️	Medium	Low-to-Medium		-46%	3 years & 11 mos
Templeton Asian Growth	⬆️	Medium	Medium-to-High			
Templeton BRIC	⬆️	Medium-to-High	High		-52%	still recovering (after 7.5yrs)
Templeton Global Bond	⬇️	Low-to-Medium	Low		-13%	3 years & 7 mos
Templeton Global Smaller Companies	⬆️	Medium	Medium-to-High		-55%	6 years & 3 mos
Sprott Enhanced Equity	⬇️	Medium	Low-to-Medium	Historical		
Sprott Enhanced Balanced	⬇️	Low-to-Medium	Low	Volatility		
NEI Select Conservative Portfolio	⬇️	Low-to-Medium	Low	Historical Volatility	-17%	3 years & 6 mos
O'Leary Canadian Dividend	⬇️	Medium	Low-to-Medium			
O'Leary Canadian Balanced Income	⬇️	Low-to-Medium	Low	Historical Volatility		
O'Leary Conservative Income	⬇️	Low-to-Medium	Low			
O'Leary Global Dividend	⬇️	Medium	Low-to-Medium			
O'Leary Emerging Markets Income	⬆️	Low-to-Medium	Medium			
RBC O'Shaughnessy U.S. Growth Fund	⬆️	Medium-to-High	High	Historical	-66%	still recovering (after 7.2yrs)
RBC Private O'Shaughnessy U.S. Growth Equity Pool	⬆️	Medium-to-High	High	Volatility		
MDPIM Canadian Bond Pool	⬆️	Low	Low-to-Medium	Historical Volatility		
MD Strategic Yield	⬆️	Medium	Medium-to-High			
MD Precision Moderate Growth Portfolio	⬆️	Medium	Medium-to-High			
Standard Life Diversified Income	⬇️	Low-to-Medium	Low		-17%	1 year & 6 mos
Standard Life U.S. Dividend Growth	⬇️	Medium	Low-to-Medium	Historical	-33%	5 years & 8 mos
Standard Life Canadian Equity Growth	⬇️	Medium-to-High	Medium	Volatility		
Standard Life Canadian Equity Value	⬇️	Medium-to-High	Medium			

*Multiple versions of funds (i.e. trust, corporate class, series F, series T, series A, etc.) are excluded for brevity. Risk stats are calculated on longer running version.
Raw data source: GlobeInvestorGold.com*

Nearly two thirds of the affected funds saw falling risk ratings with just over one third seeing a bump up in risk rating. In my view, **an investor’s exposure to risk should not fall after a multi-year run up in prices. A case can be made for risk being higher since we are likely closer than not to the next significant price drop.**”

<http://www.highviewfin.com/blog/investors-need-more-meaningful-risk-measures/>

We agree with Mr. Hallet.

There are other reports and data that challenge the idea that low volatility means lower returns . In fact many low volatility mutual funds and ETF's have outperformed benchmarks and other riskier funds. This is one more reason we distrust the robustness of the SD as a risk indicator.

If the CSA is resolute in retaining the SD rating it should, in good conscience, at least relabel the header as **Variability of Returns** and avoid using the label “Risk” that would deceive investors .

Academic research on risk disclosure makes it clear- risk disclosure should be as simple and meaningful as possible. The retail investor interprets risk as the chance of loss and that is why we have supported the use of a plain language enumeration of the principal risks and the worst 12 months metric and not a SD- based disclosure.

Some risks unique to ETF's may not be clear to investors if not annunciated. We agree with SIPA that they should be enumerated.

We have particular concerns with the rating of non-traditional ETF's like inverse and leveraged ETF's. These ETF's are truly unique. .These funds use very complex derivative structures in order to achieve certain stated benchmark prospectus return on a daily basis. These should all be rated HIGH with accompanying cautionary language as proposed.

Another comment on risk disclosure comes from behavioural finance*. **Less is More.** For that reason we urge the CSA to remove any reference to trailers if trailers do not apply and CUSIP which will confuse investors as it is not needed to make the investment decision.

* **Financial Product Disclosure: Insight from Behavioural Economics**

<http://www.mbie.govt.nz/about-us/publications/occasional-papers/2015-occasional-papers/15-01.pdf>

The CSA explain that they are still working on developing a new risk classification for mutual funds, with proposed rules expected to be published for comment by the end of the year. We hope that the CSA will align the publication of any final rules on risk classification methodology with any final rules on the proposed amendments, so that ETF managers will be able to adopt the CSA's fund risk classification methodology at its implementation, rather than having to change methodologies and disclosure after the first ETF Facts are prepared and filed.

#4 Benchmark data For index-tracking ETFs, the ETF Facts disclose the name and nature of the ETF's benchmark index in the “What does this ETF invest in?” section. However, the ETF Facts do not permit disclosure of the performance of an ETF's benchmark index. Currently, some ETFs disclose the year-by-year returns and average returns of the benchmark index that the ETF tracks to allow investors to get a sense of how closely the ETF tracks the performance of the benchmark index.

#5 Investment objective and strategy - What does the fund invest in and how does it do that? If it tracks an index, it should explain how the index works, not merely refer to the index (we've found it very difficult at times to figure out how an index works when it is a custom-

made index)

#6 Rights for Withdrawal of Purchase The various rights of rescission and rights associated with misrepresentations have not been modified for ETFs, but will apply to ETFs in respect of ETF Facts in ways that are similar to Fund Facts for mutual funds.

Investors that do not receive the ETF Facts within the prescribed timing have the right to seek damages or rescind their purchase. However, the proposed amendments do not extend to ETF investors the right of withdrawal within two days of purchase that is provided to conventional mutual fund investors (generally investing under a specified amount). ETF purchasers have, however, the same statutory rights of rescission or action that apply with respect to the prospectus for misrepresentations in the ETF Facts, since the ETF Facts will be incorporated by reference into the prospectus. Further, in some jurisdictions, investors continue to have a right of rescission associated with the delivery of the trade confirmation and may have a right of action for civil liability for misrepresentations in secondary market disclosure. This appears reasonable.

CONCLUSION

The key goal of disclosure is for investors to understand what they are buying and the risks involved. They need to understand how a particular ETF will perform in the portfolio and how it is going to perform alongside the other ETF's. We believe ETF Facts has the potential to assist in that understanding (font size should be such that seniors and others with visual issues can read the document even if this means allowing ETF Facts to be longer than two pages).

We hope this feedback is useful to you. Please do not hesitate to contact us if any additional information is required.

Kenmar agree to public posting of this Comment Letter.

Sincerely,

Ken Kivenko, P.Eng.
Kenmar Associates

REFERENCES

Low-volatility fund investment options

<http://www.fundlibrary.com/features/columns/page.asp?id=14647>

Low-Volatility ETFs Outperform in Shaky Market Conditions (Jan. 2015)

<http://finance.yahoo.com/news/low-volatility-etfs-outperform-shaky->

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[140044121.html:_ylt=AwrSbjQoq71VgS4AeRvrFAx.:_ylu=X3oDMTByb2lvbXVubGNvbG8DZ3ExBHBvcwMxBHZ0aWQDBHNIYwNzcg--](http://www.kenmar.com.au/140044121.html:_ylt=AwrSbjQoq71VgS4AeRvrFAx.:_ylu=X3oDMTByb2lvbXVubGNvbG8DZ3ExBHBvcwMxBHZ0aWQDBHNIYwNzcg--)

Leveraged ETFs | Inverse ETFs | Understanding The Risk | TradeKing
<https://www.tradeking.com/education/etfs/leveraged-and-inverse-etfs>

HK Exchange increases awareness of synthetic ETF's
<http://www.hkex.com.hk/eng/newsconsul/newsltr/2011/documents/2011-01-11-e.pdf>

How does simplified disclosure affect individual's mutual fund choices?
<https://research.hks.harvard.edu/publications/getFile.aspx?id=367>

Designing Disclosures to Inform Consumer Financial Decisionmaking: Lessons Learned from Consumer Testing
<http://www.federalreserve.gov/pubs/bulletin/2011/articles/DesigningDisclosures/default.htm>

Financial Products and Short-Form Disclosure Documents - Challenges and Trends
Melbourne Law School University of Melbourne - Law School; Centre for International Finance and Regulation (CIFR) October 8, 2014

Abstract:Recent years have seen a trend in many jurisdictions towards the adoption of short-form disclosure documents for retail financial products. This paper analyses the challenges and trends in relation to short-form disclosure documents from a comparative perspective. Developments in the following markets are examined for this purpose: Australia, New Zealand, the European Union ('EU'), Hong Kong, Singapore and Canada. The objectives of this paper are to review the international trend towards short-form disclosure documents and the policy reasons behind the trend; to examine the different approaches that have been adopted by the selected jurisdictions; and to identify the criteria and the factors that should be taken into account when jurisdictions consider which approach to adopt. In this way, the paper seeks to assist regulators in determining appropriate responses and strategies through a guide to the approaches in the selected jurisdictions, the legislative and policy underpinnings and the short-form disclosure documents themselves.

http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2510189

Designing disclosure regimes for responsible financial inclusion
<https://www.cgap.org/sites/default/files/Focus-Note-Designing-Disclosure-Regimes-for-Responsible-Financial-Inclusion-Mar-2012.pdf>

ESMA Cracks down on ETF disclosure
<http://mutfunds.net/exchangetraded-funds/esma-cracks-down-on-disclosure-for-etfs/>

ESMA's new UCITS guidelines (2012)
http://www2.deloitte.com/content/dam/Deloitte/ie/Documents/FinancialServices/investmentmanagement/2013_esma_ucits_guidelines_deloitte_ireland.pdf

The KIID - A Summary of the Requirements of the Key Investor Information Document
(March 2011)

<http://www.mondaq.com/x/124598/Compliance/The+KIID+A+Summary+of+the+Requirements+of+the+Key+Investor+Information+Document>

One of the key provisions of the UCITS IV Directive, which was approved by the European Commission on 13 January 2009, is the implementation of the key investor information document ("KIID"). This document replaces the simplified prospectus which was required pursuant to the UCITS III Directive and which was seen to have a number of shortcomings. The KIID is to be a short document containing key investor information the aim of which is to facilitate retail investors' understanding of the product being offered. It is intended to allow direct comparisons to be made more easily between UCITS funds. This briefing sets out the requirements relating to the KIID.

The simplified prospectus must include a brief and easily understandable description of all relevant and material risks associated with the investment policy of the UCITS. The KIID must provide information on the risk profile of the investment, including appropriate guidance and warnings in relation to the risks associated with investment in the UCITS. It must give a fair and balanced description of the likelihood of growth or loss. CESR recommended that the KIID include a synthetic risk and reward indicator ("SRRI") in the form of a numerical scale. The SRRI will correspond to an integer number designed to rank the fund over a scale from 1 to 7, according to its increasing level of volatility/risk-reward profile, and is based on defined annualised volatility intervals. The SRRI must be supported by a narrative explanation of the limitations of the indicator and the other material risks relevant to the UCITS which are not, or not fully, captured by the methodology for the synthetic indicator (such as credit, counterparty, liquidity and operational risk).

CESR's guidelines on the methodology for the calculation of the synthetic risk and reward indicator in the Key Investor Information Document (2010)

http://www.esma.europa.eu/system/files/10_673.pdf

Draft guidance on risk indicators and descriptions of managed funds July 2015

<https://www.fma.govt.nz/assets/Consultations/150706-draft-guidance-on-risk-indicators-and-descriptions-on-managed-funds.pdf>

Statement on Risk Disclosure for mutual Funds (1996)

<http://web.stanford.edu/~wfsharp/fer/fer96.htm>

NOTES

1. We note that Vanguard has concluded that Portfolio Turnover is a valuable piece of information for its U.S. ETF's. Given Canada's high income tax rates, it might make sense to include this metric. Ref <http://www.vanguard.com/funds/reports/sp920etf.pdf>

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2. Please see [Canadian Regulators Propose Standard Deviation as the Mandatory Risk Measurement for Canadian Mutual Funds](#) Investment Management Bulletin January 2014 Borden Ladner Gervais LLP.

3. We urge the CSA to include criteria for fund names so there is no investor confusion