Advocis

Advocis
390 Queens Quay West, Suite 209
Toronto, ON M5V 3A2
T 416.444.5251
1.800.563.5822
F 416.444.8031
www.advocis.ca

March 9, 2016

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

Care of:

The Secretary
Ontario Securities Commission
20 Queen Street West, 22nd Floor
Toronto, ON M5H 3S8
comments@osc.gov.on.ca

Me Anne-Marie Beaudoin
Corporate Secretary
Autorité des marchés financiers
800, rue du Square-Victoria, 22e étage
C.P. 246, tour de la Bourse
Montréal, QC H4Z 1G3
consultation-en-cours@lautorite.qc.ca

VIA EMAIL

Dear Sirs/Mesdames:

Re: CSA Request for Comment
Mutual Fund Risk Classification Methodology for Use in Fund Facts and ETF Facts
Proposed Amendments to NI 81-102 *Investment Funds* and Related Consequential Amendments

On behalf of Advocis, The Financial Advisors Association of Canada, we are pleased to respond to the Canadian Securities Administrators' ("CSA") consultation regarding the proposed amendments to National Instrument 81-102 *Investment Funds* and related consequential amendments that would effect a standardized investment fund risk classification methodology for use in Fund Facts and ETF 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 a 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 continues to support the principles behind the CSA's development of a standardized risk classification methodology for investment funds. As we stated in our response to CSA Notice 81-324 and Request for Comment *Proposed CSA Mutual Fund Risk Classification Methodology for Use in Fund Facts* (the "2013 Proposal"), we believe that Fund Facts, as a summary document, can be a helpful tool for consumers to use in making cursory comparisons of different investment funds.

To that end, we support initiatives that make the information in Fund Facts more relevant and reliable, which includes a standardized presentation of risk. In our view, the revised risk classification methodology released on December 10, 2015 (the "2015 Proposal") is a marked improvement over the 2013 Proposal – particularly through the retention of the current five-category structure and the adoption of the Investment Fund Institute of Canada's ("IFIC") standard deviation bands, which will avoid the needless reclassification of thousands of funds that could render millions of client accounts offside when no actual changes have occurred to the funds themselves. We laud the CSA for taking stakeholder feedback seriously to refine the Proposed Methodology while still accomplishing the objectives behind the project.

Despite this improvement, we would argue (and we believe the CSA would agree) that consumers should not be overly reliant on any one source of information before making an investment decision. We have long stated that the best role for a summary document such as Fund Facts is as a springboard to a deeper conversation between a client and his or her advisor about the opportunities and risks that a particular investment fund represents, and how that fund fits into the client's overall financial framework – being mindful of the client's particular financial position and objectives. It is through a holistic analysis, rather than the purchase of any one product, that sets consumers on the path to achieving their financial goals.

COMMENTS ON THE 2015 PROPOSAL

The use of volatility as the metric of risk

As we stated in our comments to the 2013 Proposal, it is impossible to capture all of the major risks that consumers should understand about an investment fund on Fund Facts; any attempt to capture everything on two double-sided pages would not do the exercise justice. If Fund Facts is to present one single measure of risk, we agree that – for most investment funds – it should be volatility based on the standard deviation of monthly returns due to the fact that the meaning of this metric is relatively understood by the public and its calculation is readily verifiable by third parties. (However, we do not agree with the use of standard deviation for bond funds, as we will discuss in the next section.)

Nonetheless, the CSA must be mindful that for many investors, the most prominent risk of concern is the potential of losing their capital, not the volatility of the fund's value. Therefore, we recommend that in presenting its chosen risk metric, the CSA mandate the inclusion of plain language on Fund Facts that explains the risk rating is not indicative of the risk of capital loss, but is instead a measure of the historic volatility of the value of the fund.

Further, there are many risks that are not necessarily captured by a fund's historic volatility, including currency risk, liquidity risk, concentration risk and counterparty risk. And certain funds feature unique structures that require special explanation, such as target date funds or certain income funds that use strategies such as shifting asset allocation through the expected lifecycle or the return of capital to generate a steady income stream, making the standard deviation data of such funds potentially misleading to consumers.

In the face of these considerations, we are pleased that the 2015 Proposal grants fund managers the discretion to label their fund as riskier than the Proposed Methodology would compute based on standard deviation. But for consumers to truly understand the risks and benefits of a fund before making an investment decision, they should first obtain professional financial advice and the CSA should accommodate an expansive role for such advice.

Obtaining advice provides consumers with a much better opportunity to go beyond volatility and understand all key risks, both quantitative and qualitative, of a particular investment fund, and insight as to how that particular fund fits into the consumer's larger financial plan. A professional financial advisor is able to explain complex financial concepts in a meaningful and interactive way so that clients can make a truly informed decision. To that end, we urge the CSA to mandate the inclusion of text on Fund Facts, as part of the discussion of volatility risk, recommending that consumers seek professional financial advice before making an investing decision.

Including such language may be the best solution between the CSA's research, which found that 83% of participants in the CSA's Fund Facts document testing focus group wanted a greater explanation of other specific risks,[1] and the CSA's desire to keep the presentation of risk on Fund Facts straightforward and on a common basis so as to avoid causing confusion by glossing over those risks. Concern about not being able to give these other risks their proper due in the constrained available space actually resulted in the CSA removing the list of other specific risks from Fund Facts in 2013.[2]

Historical standard deviation is inappropriate for bond funds

For bond funds, we believe the use of historic standard deviation to measure risk is inappropriate because the greatest factors affecting their volatility are forward-looking, being the time to maturity of the underlying bonds and the stability of interest rates. The price of long-term bonds tends to be much more volatile than the price of short-term bonds, and a bond's interest rate risk decreases ever year that the bond moves closer to maturity.

Rather than standard deviation, we recommend the CSA use duration to measure a bond fund's risk. Duration, a measure of a bond's price sensitivity to changes in interest rates, is the single most important determinant of bond price movements and is relatively easy for consumers to understand: if a bond fund has a duration of 5, it means that the bond fund will lose 5% of its value if interest rates rise a mere 1%. This is a very significant factor to consider for long-dated real return bond funds.

For example, the very popular iShares Canadian Real Return Bond Index ETF, with over $430 million in assets, has a duration that is over 15 years.[3] So in its case, a mere 0.5% rise in interest rates across the yield curve would cause the bond fund to lose almost 8% of its value. Many consumers would not expect a bond fund that is almost entirely comprised of quality government bonds to be that susceptible to such a small interest rate move.

Therefore, we believe that duration is the superior metric to use to categorize the risk of bond funds. Should the CSA wish, we would be pleased to assist it in establishing the numerical bands that correspond to the five risk categories on Fund Facts.

Guidance regarding individual fund risk classification and overall account and portfolio suitability

We reiterate our statement made in our comments to the 2013 Proposal: contemporaneous with it mandating use of the Proposed Methodology, the CSA should issue accompanying guidance that makes it clear that the risk classifications computed by the Proposed Methodology are not, by themselves, determinative of suitability, but one of many factors to consider as part of an advisor's Know Your Product and Know Your Client suitability assessment obligations.

---

[1] CSA Point of Sale Disclosure Project: Fund Facts Document Testing, Allen Research Corporation (September 2012), http://www.osc.gov.on.ca/documents/en/InvestmentFunds/pos_201209_fund-facts-doc-testing.pdf at page 18.
[2] CSA Implementation of Stage 2 of Point of Sale Disclosure for Mutual Funds – Delivery of Fund Facts, (2013) 36 OSCB 6001 at page 6009.
[3] See http://www.blackrock.com/ca/individual/en/literature/fact-sheet/xrb-ishares-canadian-real-return-bond-index-etf-fund-fact-sheet-en-ca.pdf.

That is, 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 investment fund which falls in the Proposed Methodology's 16-20% band is *de facto* suitable; conversely, any investment fund that falls outside that band should not be *de facto* unsuitable. Since volatility risk does not capture all of the relevant material risks, it would be improper for industry or consumers to conflate the Proposed Methodology's risk computation with a proper suitability assessment.

Further, many professional advisors utilize modern portfolio theory ("MPT"), including a variety of specialized software applications that assist in creating MPT-optimized portfolios, to better serve their clients. In doing so, any particular investment fund is likely to be grouped with several other funds in the client's account. So whether the account's overall risk exposure is compliant with the client's risk tolerance must be viewed holistically, in the context of all the funds in the client's account and the consumer's financial plan, including the client's investment objectives, tax considerations and time horizon. For a particular client account with a "medium risk" tolerance, a mix of higher volatility and lower volatility investments may be better suited, rather than simply filtering for those funds that the Proposed Methodology deems as representing medium 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 upon implementation of the Proposed Methodology, the CSA provide accompanying guidance which makes clear that despite the regulated risk presentation brought about by the Proposed Methodology, a fund's risk classification cannot be used to directly determine whether the consumer's account is in compliance with the risk tolerance stated in his or her KYC and KYP suitability profile; overall compliance must be judged more holistically, in concert with the other investments in the account and in the context of the client's personal situation.

Wraps, Funds-of-Funds and Portfolio Series Investment Solutions

We believe that special attention must be paid to wraps, also known as funds-of-funds and portfolio solutions (amongst other names), which have become very popular "all in one" choices for many retail investors. A typical wrap is made up of several (often eight to 12) underlying mutual funds, each of which would normally have its own Fund Facts and risk classification presented thereon. Fund manufacturers use MPT to assemble a mixture of more aggressive funds (such as emerging market equity funds), pooled with more conservative funds (such as domestic bond funds), and it is the combination that strikes the risk-reward balance that makes these products so popular.

Currently, on a wrap's Fund Facts, industry practice has been to present only a single "top line" risk classification that is supposed to represent the wrap's overall risk – there is no disclosure of the risk of the wrap's individual components. Doing so usually means that the wrap is bluntly labelled as being medium risk. As there are many ways to get to “medium”, we believe this approach strips valuable context from the wrap’s risk classification.

A more insightful approach would be for the wrap’s Fund Facts (and its prospectus) to summarize the risk profile of the underlying funds as a weighted percentage composition. For example, instead of simply labelling a wrap as “medium” risk, a fund company could describe the wrap’s risk as: "10% high, 15% medium-high, 60% medium and 15% low", based on the weighting and risk classification of the wrap’s component funds. This would better allow a client and financial advisor to understand how the investment solution fits with the client's profile.

Transition Issues

According to the 2015 Proposal, the CSA expects to publish final rules in the fall of 2016 (the “Publication Date”) and have the Proposed Methodology come into force three months after the Publication Date (the “In Force Date”). After the In Force Date, the risk level of conventional mutual funds and exchange-traded funds will be determined in accordance with the Proposed Methodology for each subsequent filing of Fund Facts or ETF Facts and at least annually.

In our opinion, this transition schedule is too aggressive. While the 2015 Proposal contains many improvements over the 2013 Proposal that should smooth the implementation of the Proposed Methodology, there will inevitably be unforeseen issues that will take additional time to address. Because of the large number of funds to process, fund managers will require at least one year to upgrade and test their systems and generate the new risk ratings.

Dealers and advisors will have a more onerous task, as funds not currently employing the IFIC methodology could see a change in their risk rating, impacting client accounts. SRO requirements require that such events be reviewed through client meetings to explain changes and ensure ongoing suitability. Dealers would have to update their policies regarding suitability and their account supervision systems. Therefore, we believe that dealers and advisors would require a separate transition period of approximately two years.

--

We look forward to working with the CSA as it works to implement the Proposed Methodology. 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,

[redacted]

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

[redacted]

Caron Czorny, FLMI, ACS, CFP, CLU, CH.F.C., EPC, CHS, ICD.D
Chair, National Board of Directors