

March 9, 2016

BY EMAIL

British Columbia Securities Commission
Alberta Securities Commission
Financial and Consumers Affairs Authority of Saskatchewan
The 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

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 (Québec) H4Z 1G3
consultation-en-cours@lautorite.qc.ca

-and-

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

Dear Sirs/Mesdames:

Re: CSA 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 (the “Proposed Amendments”)

The Canadian Advocacy Council¹ for Canadian CFA Institute² Societies (the CAC) appreciates the opportunity to respond to the Proposed Amendments.

¹The CAC represents more than 15,000 Canadian members of the CFA Institute and its 12 Member Societies across Canada. The CAC membership includes portfolio managers, analysts and other investment professionals in Canada who review regulatory, legislative, and standard setting developments affecting investors, investment professionals, and the capital markets in Canada. See the CAC's website at <http://www.cfainstitute.org/cac>. Our Code of Ethics and Standards of Professional Conduct can be found at <http://www.cfainstitute.org/ethics/codes/ethics/Pages/index.aspx>.

² CFA Institute is the global association of investment professionals that sets the standard for professional excellence and credentials. The organization is a champion for ethical behavior in investment markets and a respected source of knowledge in the global financial community. The end goal: to create an environment where investors' interests come first, markets function at their best, and economies grow. CFA Institute has more than 135,000 members in 151 countries and territories, including 128,000 CFA charterholders, and 145 member societies. For more information, visit www.cfainstitute.org.

As noted 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 CAC is generally supportive of a standardized risk methodology. We are also supportive of mandating the same methodology for use in the proposed ETF Facts.

We understand that the CSA has reviewed alternative measurements but is continuing to propose standard deviation as the sole risk indicator because it is a widely accepted measure of volatility. We continue to question the premise that volatility is the only risk measure that should be required for the Fund Facts and ETF Facts. Standard deviation alone does not help explain whether a fund's volatility is due to exposure to the market or the manager's investment performance. A low standard deviation, and thus low realized volatility over a time period, does not necessarily mean that an investment is devoid of other substantial risks. In addition, the use of standard deviation alone as a volatility and risk measurement is not, in our view, sufficient, particularly where a fund has not been in existence long enough for that track record to have any statistical meaning or where the volatility of a benchmark is substituted and may not properly represent the volatility or other risks of the mutual fund or ETF in question.

In some respects, the use of standard deviation as a volatility measure is circular. While many disclaimers are required to the effect that past performance is not an indicator of future results, standard deviation is inherently calculated on a return stream of past performance and is thus an implicit endorsement of the use of past returns in an investor's evaluation of their risk and return goals.

We do not believe that most investors understand the meaning of standard deviation within the context of their portfolio, nor have a sufficient understanding to interpret the results. As an example of additional disclosure, in conjunction with the use of the "risk bands", it could be helpful for an investor to be provided with information such as the amount of money in dollar terms that could be lost if an investment fell within one of the bands – i.e. \$1000 in a high risk band could have lost \$X over the last 10 years. If the CSA were to require additional information in conjunction with the existing risk scale, particularly in graphic form, it would provide additional transparency to retail investors.

Investors usually perceive risk as the combination of the totality of risks affecting their portfolio, including risks other than volatility risk. The potential downside to a mutual fund or ETF investment may in fact be greater than that indicated by normal historical volatility. We understand that under the revised Proposed Amendments, the investment risk level of a mutual fund or ETF may be increased beyond the level in which it might be placed based on the methodology. We would encourage the CSA to provide additional guidance with respect to when such an increase might be appropriate.

While standard deviation is an informative measure, it is not a complete measure of risk as has been highlighted above, and can mask risks that arise as a result of the complexity of an investment product. As an illustrative example, a short-term fixed income mutual fund or ETF could have very low historical volatility over the measurement period in question, but be quite risky as a result of the complexity of the fund's underlying investments, some of which could have very asymmetric

risk profiles in the event of a credit event, liquidity issues, or an interest rate shock. The risk rating of the fund, based on standard deviation, would have given the investor no insight into the asymmetric risk profile and complexity of the fund's investments. The Journal of Finance has recently published a paper [A Risk and Complexity Rating Framework for Investment Products] (Koh et al.) discussing a complexity rating framework, which would help inform and augment traditional risk ratings. The paper describes other vectors that could be considered for risk measurement and required mutual fund and ETF disclosures by the CSA in future projects. The CAC would be happy to engage with interested CSA working group members on this point for a more detailed dialogue in future.

Concluding Remarks

We thank you for the opportunity to provide these comments. We would be happy to address any questions you may have or to meet with you to discuss these and related issues in greater detail. We appreciate the time you are taking to consider our points of view. Please feel free to contact us at chair@cfaadvocacy.ca on this or any other issue in future.

(Signed) "*Michael Thom*"

Michael Thom, CFA
Chair, Canadian Advocacy Council