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Delivered By Email: comments@osc.gov.on.ca, consultation-en-cours@lautorite.qc.ca

British Columbia Securities Commission
Alberta Securities Commission
Financial and Consumer 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

Attention:

The Secretary
Ontario Securities Commission
20 Queen Street West
22nd Floor
Toronto, Ontario M5H 3S8

Me Anne-Marie Beaudoin
Corporate Secretary
Autorité des marchés financiers
800, rue du Square-Victoria, 22e étage
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Montréal (Québec) H4Z 1G3

Dear Sirs and Mesdames:

CSA Notice and Request for Comment – CSA Mutual Fund Risk Classification Methodology for Use in Fund Facts and ETF Facts. Proposed Amendments to National Instrument 81-102 *Investment* Funds AND Related Consequential Amendments.

We are writing to provide you with comments on behalf of the Members of IFIC with respect to the CSA Notice and Request for Comment published on December 10, 2015 regarding the CSA Mutual Fund Risk Classification Methodology (the "CSA Methodology").

We note that the revised methodology responds to a number of concerns and suggestions raised by IFIC and industry participants in relation to the 2013 Proposed CSA Mutual Fund Risk Classification Methodology, and that it now largely reflects the methodology currently in use by the majority of the industry as articulated in the IFIC Voluntary Guidelines for Fund Managers Regarding Fund Volatility Risk Classification (the "IFIC Methodology")

General Comments

Standardized Methodology

We fully support the CSA's intention to mandate a standardized fund risk classification methodology. A voluntary approach has served market participants well over the past decade; however, it has not been adopted by all Canadian fund managers, resulting in inconsistencies and causing potential confusion for investors.

Risk Indicator

We agree with the CSA's choice of standard deviation as the most suitable risk indicator. Historical volatility risk as measured by the standard deviation of fund performance is the most comprehensive, easily understood form of risk.

Calculation of Standard Deviation

It should be noted that there are some differences in the calculation of standard deviation in the CSA Methodology as compared to the IFIC Methodology; however, we do not expect a material impact on risk classification if fund managers use the standard deviation calculation as outlined in the CSA Methodology, as opposed to the three and/or five-year standard deviations in the IFIC Methodology.

The standard deviation calculation in Step 2 of the IFIC Methodology is consistent with the calculation as laid out in the CSA Methodology. In the IFIC Methodology, the results are compared to an appropriate benchmark index (a broad range of market indices and comparative benchmarks was selected to represent the different asset categories available to investors). If the fund's standard deviation for each period does not differ materially from the appropriate index, the fund is categorized to the appropriate volatility classification. **However**, if the fund's standard deviation for each period differs materially from the appropriate index, the average (since inception) of the rolling three and/or five-year standard deviations for the fund are determined (Step 3 of the IFIC Methodology). This is compared to the standard deviation bands as presented in Appendix 1 of the IFIC Methodology in order to determine the appropriate volatility classification.

Formation of an Advisory Committee on Fund Risk

It is important that the methodology for assessing fund risk be kept current through regular reviews and updates that reflect product changes, market factors and a host of other considerations. The IFIC Methodology is a result of careful thought and analysis by a number of highly qualified and experienced experts on IFIC's Fund Risk Classification Task Force who developed the original methodology and who review it annually to ensure it remains meaningful and relevant.

We strongly recommend that the CSA establish a similar committee to ensure that that CSA Methodology remains relevant with market trends and volatility. It is essential that this committee include broad industry participation, along with representatives from the regulators, data providers, and academics. We recommend that the CSA Methodology be reviewed by this committee on at least an annual basis.

Members from IFIC's Fund Risk Classification Task Force should be considered by the CSA as members of any advisory committee that is established due to their extensive experience and expertise in this area.

Comments on Key Changes to the 2013 Proposal

Application of Proposed Methodology to ETFs

We agree that the CSA Methodology be used both for exchange-traded funds and conventional mutual funds.

Investment Risk Level and standard deviation ranges

We support the CSA retaining the five-category risk scale currently used in the Fund Facts. The fact that the proposed risk band break points are consistent with those used in the IFIC Methodology will ensure a smooth transition to the CSA Methodology.

Use of a Reference Index (Mutual funds with less than 10 years of history)

We agree with the principle of using a reference index, or a composite of several market indices, as a proxy for determining the risk rating of a fund or ETF that does not have a sufficient 10-year performance history, however, the CSA Methodology as currently proposed does not provide sufficient guidance and/or flexibililty to fund managers, particularly with regard to innovative strategies. It would be helpful if the CSA could provide a concrete example of a new fund (that follows an unconventional or innovative strategy) and the process that would be taken to select an appropriate reference index for that fund.

We note that the requirements that the index be “highly correlated” to the returns of the fund or ETF and contain a high proportion of the same securities would likely not be appropriate or achievable for many fund managers, in particular those pursuing innovative approaches such as low beta strategies. In their 2011 paper “Benchmarking Low-Volatility Strategies”, Blitz and van Vliet discuss benchmarking a low-volatility strategy against the capitalization-weighted market index and note that “...a straight comparison of returns is not appropriate, given that low-volatility strategies tend to exhibit significantly lower risk (volatility, beta).”

The CSA Methodology does not provide sufficient details on the steps that should be taken if the chosen reference index does not meet all 10 principles (a to j) outlined in the Request for Comments. It would be useful if the CSA could provide guidance regarding how to choose a proxy index in this case.

As mentioned in our response to CSA Notice 81-324, we would caution the CSA that determining an appropriate reference index may be difficult for funds or ETFs which intend to behave differently than any existing reference index. In those situations where there is little or no fund history, and where there is no reference index with a 10-year history that is appropriate for the fund, it is not clear how the CSA would recommend the CSA Methodology be applied. Ultimately, each fund manager must ensure that the risk rating, which forms part of its disclosure record, is not misleading. The absence of discretion to select an appropriate reference index creates the risk that a fund manager may not select the applicable risk rating. Accordingly, we recommend permitting the fund manager discretion, in limited circumstances, to select a reference index (or composite of reference indices) which may not, in all cases, be "highly correlated" to the returns of the fund or ETF or have a high proportion of the same securities of such fund or ETF. In such instances, the use of discretion must be disclosed in the description of the reference index to be included in the MRFP. Finally, we ask that the CSA revisit the guiding principles for selecting a reference index and provide updates to the guiding principles on a routine basis after the methodology is finalized.

Members of IFIC’s Fund Risk Classification Task Force would be pleased to engage with the CSA further on the topic of selecting an appropriate reference index.

Frequency of determining the investment risk level of a mutual fund

We agree with the frequency of determining the investment risk level of a mutual fund (i.e. the investment risk level must be determined upon the filing of a Fund Facts or ETF Facts and, in any case, at least annually).

Record of standard deviation calculation

We agree with the requirement to maintain records of standard deviation calculations for a period of 7 years.

Other Comments

Adjustments to Disclosure Documents including Fund Facts

We note that once the CSA Methodology is mandated, changes will need to be made to disclosure documents, including the Fund Facts. The 'How risky is it?' section of the Fund Facts currently states: "*When you invest in a fund, the value of your investment can go down as well as up. XYZ Mutual Funds has rated this fund's risk as medium.*" With the CSA Methodology, and specifically the 'Use of a Reference Index' section, fund managers are now following a prescribed methodology. As a result, we feel that the language in the disclosure documents should be amended to reflect this.

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Thank you for providing us with an opportunity to comment on this important issue. We appreciate the careful thought and consideration the CSA has given throughout this consultation process. Should you have any questions or desire to discuss these comments, please contact me directly by phone at 416-309-2325 or by email at ibragg@ific.ca.

Yours truly,

THE INVESTMENT FUNDS INSTITUTE OF CANADA

[redacted]

By: Ian Bragg
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