

## **Notice relating to the findings of a thematic review of the investment risk classification methodology**

### **Background**

As part of its investment fund oversight program, the *Autorité des marchés financiers* (the “Authority” or “we”) conducted a thematic review of the investment risk classification methodology disclosed in fund facts and ETF facts documents (“fund facts document”). This review was conducted on a sample of reporting issuer mutual funds, including exchange-traded mutual funds, whose investment fund managers are headquartered in Québec (the “mutual funds”).

New provisions on the investment risk classification methodology (the “new methodology”) came into effect on September 1, 2017. Therefore, the new methodology had to be applied in documents filed as of September 1, 2017.

Part 15.1 of Regulation 81-102 respecting Investment Funds<sup>1</sup> (“Regulation 81-102”) introduces the requirement to determine the investment risk level (the “risk level”) in accordance with the new methodology prescribed in Appendix F Investment Risk Classification Methodology to said regulation (“Appendix F”). Accordingly, amendments were also made to Form 81-101F1 Contents of Simplified Prospectus of Regulation 81-101 respecting Mutual Fund Prospectus Disclosure<sup>2</sup> (“Form 81-101F1”) and Form 41-101F2 Information Required in an Investment Fund Prospectus of Regulation 41-101 respecting General Prospectus Requirements<sup>3</sup> (“Form 41-101F2” and “Regulation 41-101”).

### **Purpose and scope**

This review was conducted primarily using publicly available information, to verify whether the risk level disclosed in the fund facts document was actually determined in accordance with the methodology prescribed by regulation, whether the information disclosed in the various fund documents complied with regulatory requirements, and whether the material change requirements were satisfied.

By means of this notice, the Authority wishes to share the principal findings, which, if applicable, have already been provided to the investment fund managers concerned as part of this review, and to communicate the areas for improvement it identified.

### **Principal findings and areas for improvement**

Here are some sample-based statistics presented in order of importance:

**9%** of mutual funds did not use the new methodology;

**13%** of mutual funds made errors in calculating the standard deviation;

**35%** of mutual funds had areas of non-compliance with regulatory disclosure requirements;

**13%** of mutual funds used a reference index in the management report of fund performance (“MRFP”) that was different from the one used in the fund facts document;

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<sup>1</sup> CQLR, c. V-1.1, r. 39

<sup>2</sup> CQLR, c. V-1.1, r. 38

<sup>3</sup> CQLR, c. V-1.1, r. 14

9% of mutual funds presented different risk levels under two headings of the fund facts document.

### **I. Failure to use the methodology prescribed by regulation**

In some cases, we noted that the methodology prescribed by regulation since September 1, 2017 had not been used. This failure to comply with regulatory requirements sometimes resulted in incorrect risk levels being disclosed in the most recent fund facts document. We remind you that investment fund managers are responsible for complying with the securities law requirements that apply to their investment funds.

### **II. Errors in calculating the standard deviation**

We identified areas of non-compliance with certain provisions of Appendix F relating to how the standard deviation was calculated, which in some cases resulted in an incorrect risk level being provided in the most recent fund facts document. For example:

- Use of the monthly net asset value per security of the series or class of securities of the mutual fund (the "series") instead of its monthly return as prescribed in subsection (1) of Item 2 of Appendix F;
- Use of monthly returns over a period that is different than the 120 months prescribed in subsection (1) of Item 2 of Appendix F and does not end within 60 days before the date of the fund facts document as prescribed in Instruction (1) to Item 4 of Part 1 of Form 81-101F3 Contents of Fund Facts Document of Regulation 81-101 and the Instructions to Item 4 of Part 1 of Form 41-101F4 Information Required in an ETF Facts Document of Regulation 41-101;
- Use of incorrect monthly returns of a reference index, resulting in non-compliance with subsection (2) of Item 4 of Appendix F.

### **III. Failure to disclose, in the prospectus, the required information relating to the applicable underlying fund, another mutual fund or the reference index**

We noted that the required information concerning the applicable underlying fund, another mutual fund or the reference index (including the weighting of a composite of several permitted indexes) was not always disclosed in the prospectus (or was inaccurate) when the fund had less than 10 years of performance history as prescribed in subsection (b) of Item 9.1 of Part B of Form 81-101F1 and subsection (b) of Item 12.2 of Form 41-101F2.

We remind you that use of the returns of the underlying fund, another mutual fund or the reference index is required under Item 4 of Appendix F when determining the risk level of a mutual fund if it has less than 10 years of performance history, particularly in the following cases:

- If it has been less than 10 years since securities of the mutual fund were first available to the public (Item 4 of Appendix F);
- If a series of the mutual fund, available to the public for the first time less than 10 years ago, has an attribute that results or could result in a different risk level for the series from that of the mutual fund (Item 3 of Appendix F);
- If there has been a change, within the past 10 years, to the fundamental investment objectives of the mutual fund pursuant to paragraph 5.1(1)(c) of Regulation 81-102 (Item 6 of Appendix F).

#### *Areas for improvement*

The returns of the reference index, used to determine the risk level, are sometimes denominated in a different currency from the currency of the net asset value of the mutual fund or one of its

series (for example, if the mutual fund or one of its series employs currency hedging), in which case we expect the brief description of the reference index, prescribed in subsection (b) of Item 9.1 of Part B of Form 81-101F1 and subsection (b) of Item 12.2 of Form 41-101F2, to specify the currency in which the index is denominated.

#### **IV. Reference index used in the MRFP differs from the one used in the fund facts document**

We noted that either the reference index used to determine the risk level or the currency in which the index is denominated was sometimes different from the reference index or currency used in the section on the annual compound returns of the most recent MRFP.

In light of their distinct purposes, the regulations offer the possibility, when warranted, of disclosing a reference index in the MRFP that is different from the one used to determine the risk level of the mutual fund. In such a case, as the requirements in Form 81-106F1 Contents of Annual and Interim Management Report of Fund Performance of Regulation 81-106 respecting Investment Fund Continuous Disclosure<sup>4</sup> and of those in Appendix F are both based primarily on the returns of an index that is representative of the performance of the mutual fund, we expect the investment fund manager to be able to explain his or her decision using a financial analysis demonstrating that different reference indexes are used primarily to facilitate investor comprehension.

#### **V. Inconsistency in risk levels provided in the fund facts document**

We noted that, in some cases, the risk level indicated in the fund facts document under the sub-heading “Risk rating” did not match the risk level indicated under the heading “Who is this fund for?”.

To avoid any confusion, please ensure that the information disclosed is consistent.

#### **Conclusion**

As a result of these findings, we compelled certain mutual funds to make immediate or prospective changes to the prospectus and fund facts document.

Please remember that the investment risk classification methodology prescribed in the regulations applicable to mutual funds mainly ensures that disclosure in this area is transparent and consistent so that investors can more readily compare the various mutual funds. This methodology therefore contributes directly to achieving the investor protection objectives underlying the fund facts regime.

It is primarily for these reasons that we expect investment fund managers to be rigorous in applying this methodology, particularly with respect to elements that allow for a measure of discretion.

The Authority expects investment fund managers to use the findings and areas for improvement in this notice to validate their application of the investment risk classification methodology and its consistency with the information provided to investors and available to the public.

As part of its investment fund oversight program, the Authority will continue to closely monitor how the issues identified during this thematic review evolve.

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<sup>4</sup> CQLR, c. V-1.1, r. 42

### **Additional Information**

Please refer your questions to:

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