OSC Investor Advisory Panel
c/o Ursula Menke, Chair
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February 19, 2016

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

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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 Investor Advisory Panel is pleased to respond to the Canadian Securities Administrator's proposed amendments for its Mutual Fund Risk Classification Methodology for Use in Fund Facts and ETF Facts. We see the prescribed methodology as a major step forward in eliminating subjectivity in the calculation of risk rating – from the perspective of investors, it will provide consistency, transparency, and the ability to compare products. We are also pleased to see regulators proposing to apply the same methodology to both mutual funds and exchange-traded funds ("ETFs").

We do, however, have some concerns and suggestions for the CSA as it moves forward to refine the risk categorization. Our recommendations echo and build upon concerns previously outlined in our comment letter to the CSA submitted on March 7, 2014, where we expressed our views on the shortcomings of standard deviation as a single measure of a fund's risk.

We have made several proposed recommendations below:

Representing Standard Deviation – In the proposed methodology, a mutual fund or ETF will be given an investment risk level that corresponds to a standard deviation range – low (0 to less than 6), low to medium (6 to less than 11), medium, (11 to less than 16), medium to high (16 to less than 20), and high (20 or greater). This approach, however, is less precise than the calculated outcome – and it dilutes the results, providing less accurate volatility information to investors.

Recommendation – Find a way to represent the full spectrum of standard deviation calculations numerically rather than assigning a high-low rating system that is less transparent and accurate. In addition, explain concretely what that number actually means to the investor.

Performance history – Standard deviation is a measure of price volatility, but does not show actual loss of capital. While standard deviation may be seen as a component of risk assessment, volatility alone does not represent the risk level of a fund. Additional factors to consider include probability and potential maximum loss of capital (e.g., based on a maximum 10-year performance history). Moreover, standard deviation may not capture true volatility in some exotic ETFs that use complex strategies nor does it capture the risks in products such as life cycle and return of capital funds.

Recommendation – In addition to standard deviation, include bar charts that show (absolute) worst (3-month period) and best (3-month period) performance during the life of the fund with a maximum of 10 years. The Panel would like to again refer the CSA to the alternative proposed in our March 7, 2014, comment letter. Also, consider showing the number of trading days where price changes were greater than 1% during the life of the fund with a maximum of 10 years.

Tail risk – Standard deviation assumes a normal distribution (curve) which does not address how a fund behaves in extreme market conditions (i.e., 2001, 2008, 2015). Fat tails can impact the performance of a fund and lead to extreme losses– that puts investors at risk. We encourage the CSA to follow more up-to-date comprehensive measures being developed and explored by large financial institutions, specifically the use of "expected shortfall" (or Conditional VaR (CVAR)).

Recommendation – Consider warning investors that not all investments have a normal return distribution – and that market conditions can change suddenly and can increase volatility unexpectedly. The frequency of sudden unexpected changes in capital market conditions has been increasing over the past three decades.

Standard deviation not the only measure of risk - While the IAP agrees that standard deviation may be one aspect of risk assessment, it should not be the only one. We are concerned that the CSA is focused solely on standard deviation as an adequate measure of a fund's risk. In addition to volatility, the CSA must consider listing additional risk elements, where applicable, so that investors have an appreciation of the different types of risks associated with their investment (e.g., liquidity, leverage, duration, holding period, inflation).

Recommendation – Broaden the spectrum of risk assessment aspects to be disclosed. For fixed income funds add duration (to measure the sensitivity of the price to a change in interest rates), and disclosure of issuer and risk rating of holdings.

Address liquidity risk (i.e., indicator of the fund's ability to meet unit/shareholder redemption requests and dilutive impact of significant size buy and/or sell transactions). We realize that development of a standard method to calculate liquidity risk is complex and will take time. We urge the CSA to review the work the U.S. Securities and Exchange Commission (SEC) has undertaken towards mandating adequate liquidity risk disclosure and to strive to mandate a metric for this disclosure in due course concurrent with the SEC. Until such time a metric will have been decided on and mandated, the investor should be made aware of liquidity risk through a brief description.

Where applicable, disclose additional risks (including a description) such as counterparty risk, currency risk, concentration risk, interest rate risk, operational risk, strategy (complexity) risk (e.g., use of derivatives, hedges, or short selling), regulation risk, leverage risk, as well as fund-specific risks, such as risks applicable to life cycle funds or return of capital funds, and authorized participant concentration risk for ETFs (in other words, when an ETF is overly reliant on a small number of authorized participants to generate liquidity and avoid tracking error). Depending on the fund, some should be highlighted, others may be cross referenced to the risk section in the prospectus.

If the pertinent section only shows standard deviation, we recommend that it be more appropriately referred to as “volatility” rather than “risk”.

Use of blended historical data - The Panel is deeply concerned with the CSA’s acceptance of blended historical data in cases where a fund does not have actual historical data for a period of 10 years. Where a fund does not have the required historical data, actual fund data should never be combined /blended with proxy/reference index data. Such a practice could be or could be seen at best as misleading, at worst as misrepresentation.

Recommendation: Use actual historical fund data for the period that they are available, and show the outcome specifying the period; in addition, separately show the applicable proxy/reference index data for the required 10-year period, specifying the proxy/index.

Basis for calculation - We agree with the CSA on using NAV for calculation, provided that the impact of MER on return will be clearly shown.

Conclusion

While the Panel continues to support prospectus summary documents and is pleased with the proposed mandate, we urge CSA to continue working towards enhancing the risk disclosure mandate to make it more comprehensive, and meaningful to the investor.