



**Franklin Templeton Investments Corp.**  
200 King Street West, Suite 1500  
Toronto, Ontario, Canada M5H 3T4  
telephone 416-957-6000  
toll free 1-800-897-7280  
facsimile 416-364-6615  
www.franklintempleton.ca

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**VIA EMAIL**

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)  
Superintendent of Securities, Department of Justice and Public Safety, Prince Edward  
Island  
Nova Scotia Securities Commission  
Securities Commission of Newfoundland and Labrador  
Superintendent of Securities, Northwest Territories  
Superintendent of Securities, Yukon  
Superintendent of Securities, Nunavut

**Attention:** The Secretary  
Ontario Securities Commission  
20 Queen Street West  
22<sup>nd</sup> Floor, Box 55  
Toronto, ON M5H 3S8

Me Anne-Marie Beaudoin  
Corporate Secretary  
Autorité des marchés financiers  
800, square Victoria, 22<sup>e</sup> étage  
C.P. 246, tour de la Bourse  
Montréal (Québec) H4Z 1G3

Dear Sir/Madame:

**Re: 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**

Franklin Templeton Investments Corp. (“FTIC”) welcomes the opportunity to make a submission with respect to the Canadian Securities Administrators (“CSA”) Notice and

Request for Comment on Proposed Amendments to National Instrument 81-102 *Investment Funds* and Related Consequential Amendments (the “Proposed Amendments”), which mandate a CSA risk classification methodology (the “Proposed Methodology”) for use by fund managers to determine the investment risk level of conventional mutual funds and exchange-traded mutual funds for disclosure in the Fund Facts document (“Fund Facts”) and in the ETF Facts document.

FTIC is a wholly owned subsidiary of Franklin Resources, Inc., a global investment organization operating as Franklin Templeton Investments. Through its subsidiaries, Franklin Templeton Investments provides global and domestic investment advisory services to the Franklin, Templeton, Franklin Bissett, Franklin Mutual Series, and Franklin Quotential funds and institutional accounts. In Canada, FTIC has more than 500 employees providing services to nearly 500,000 unitholder accounts and over 100 pension funds, foundations and other institutional investors.

FTIC supports a mandated, standardized risk classification methodology as this would ensure uniform and consistent risk disclosure amongst mutual funds, which would make comparing funds easier and more meaningful for investors. However, we do have some concerns with the Proposed Methodology, which include: (1) the use of discretion to increase the investment risk level of a mutual fund; (2) methodology issues related to the use of a reference index and the lack of ability to use other proxies for mutual funds with less than 10 years of history; and (3) disclosure issues related to the use of a reference index.

### **The use of discretion to increase the investment risk level of a mutual fund**

The Proposed Methodology allows a fund manager to increase the investment risk level of a mutual fund “if doing so is reasonable in the circumstances”. FTIC agrees that fund managers should be able to exercise this limited amount of discretion over fund investment risk levels provided that: (1) fund managers adopt written policies and procedures that set out the circumstances under which a fund investment risk level may be raised; and (2) fund managers disclose to investors, preferably in the Fund Facts, that the investment risk level of the fund has been increased over the level dictated by the fund’s standard deviation.

Because allowing fund managers to increase a fund’s investment risk level introduces an element of judgement or discretion to the fund risk classification process, FTIC believes that it would be appropriate for the CSA to provide clarification of the phrase “reasonable in the circumstances”. Providing additional detail on the circumstances in which the CSA considers that it may be reasonable for fund managers to raise a fund’s investment risk level would reduce or eliminate the discretion to be applied by fund managers and would be helpful to fund managers in crafting written policies and procedures in this area.

While a fund manager must keep and maintain records that document why it was reasonable to increase the investment risk level of a mutual fund, an investor comparing Fund Facts for two different funds will not know if a fund manager has exercised its discretion to increase the risk rating of a fund, and thus may select a mutual fund based on incomplete information. Requiring fund managers to disclose circumstances when

discretion over fund investment risk level was exercised in the Fund Facts would make comparing mutual funds easier and more meaningful to investors.

**Methodology issues related to the use of a reference index and the ability to use other proxies for mutual funds with less than 10 years of history**

The Proposed Methodology requires fund managers to select a reference index that reasonably approximates the “return on investment” of any mutual fund that has less than 10 years of performance history. Many funds do not have 10 years of performance history, which would require the fund manager to use reference indices as a proxy for fund returns for a significant period of time. While FTIC agrees with certain of the reference index selection guidelines outlined in the Proposed Methodology, we note that the guidelines will prove problematic to apply in the case of new funds and funds that do not invest in a manner that has a high degree of correlation to a reference index. In these two situations, we believe it will be difficult to select a reference index that: (1) has returns highly correlated to the returns of the fund; (2) contains a high proportion of the securities represented in the fund’s portfolio with similar portfolio allocations; (3) has a historical systematic risk profile similar to the fund; and (4) has security allocations that represent invested position sizes on a similar pro rata basis to the mutual fund’s total assets. We believe that using a reference index with little or no correlation to fund performance could be confusing or misleading to investors.

Given the issues surrounding the use of a reference index, we believe that for funds with less than 10 years of performance, the Proposed Methodology should allow a fund manager to use either a clone fund or a Sister Fund (defined below) as proxies for determining fund risk.

We note that in the “Comment on the 2013 Proposal” table, the CSA has indicated that where an underlying fund has a 10 year history and the top fund’s investment objectives and strategy is to “clone” the underlying fund, staff may consider allowing, through exemptive relief, the use of the underlying fund’s volatility of returns for the purposes of determining the top fund’s investment risk level. We are encouraged that the CSA has acknowledged that funds invested, directly or indirectly, in the same pool assets should have consistent volatility risk calculations. However, we believe that the Proposed Methodology should specifically allow top funds that meet the definition of “clone fund” under NI 81-102 to use the underlying fund’s volatility of returns for the purposes of determining the clone fund’s investment risk level without having to seek exemptive relief. Such an approach would be consistent with how clone funds are dealt with in sections 2.5 and 10.6 of NI 81-102.

Furthermore, we believe that the CSA should permit the ability to use Sister Funds as proxies for mutual funds with less than 10 years of performance. FTIC offers a number of mutual funds in Canada that are the same or very similar in strategy to funds offered by Franklin Templeton Investments in other parts of the world under the Undertakings for Collective Investments in Transferable Securities (“UCITS”) directives (the “Sister Funds”). These Sister Funds have the same portfolio manager, investment objective and strategies as the applicable Canadian fund. In addition, because the Sister Funds are distributed in accordance with the UCITS directives, they are subject to investment

restrictions and practices that are substantially similar to those that govern the Canadian funds. We believe that a Canadian fund with less than 10 years of history should be permitted to use its Sister Fund's volatility of returns for the purposes of determining the Canadian fund's investment risk level, provided that the Sister Fund: (1) has a 10 year performance history; (2) is subject to the UCITS directives and (3) has the same portfolio manager, investment objectives and strategies as the Canadian fund. The Sister Fund's volatility of returns would provide a better proxy for understanding the risk of a fund than the volatility of returns of a reference index. We recommend that the CSA allow the use of the Sister Fund's volatility of returns until the new Canadian fund has sufficient performance history of its own.

Where a clone fund or a Sister Fund is not available, rather than wholly replacing a mutual fund's standard deviation metrics with those of a reference index, FTIC believes the approach suggested by the CSA in Notice 81-324 and Request for Comment on the *Proposed CSA Mutual Fund Risk Classification Methodology for Use in Fund Facts* (the "2013 Proposal"), which contemplated fund managers using a reference index to impute missing fund data is a more accurate approach. In the 2013 Proposal, there was specific reference to the ability to use actual fund returns as far back as available but to then link fund returns to reference index returns to backfill missing fund returns from periods prior to fund inception. This reference is missing from the Proposed Methodology.

In our view, wholly replacing missing fund data with data from a reference index without linking fund returns to reference index returns is problematic, except in the case of index funds or ETFs that seek to replicate a specific index. In these instances, the reference index would be representative of the fund's returns and therefore the particular fund's volatility risk. In all other cases, however, a reference index will not be truly representative of the style of the portfolio manager for a given fund. This discrepancy would impair the usefulness of the risk classification as a reflection of the actual fund's volatility risk.

Given the issues surrounding the use of a reference index, where a clone fund or Sister Fund is not available as a proxy for a new fund's returns, FTIC urges the CSA to reconsider a five year period for standard deviation calculation or to revert to the 2013 Proposal for this aspect of the methodology, where linking to a reference index for periods prior to inception was specifically mentioned.

### **Disclosure issues related to the use of a reference index**

Currently, the only disclosure document in which fund managers are required to compare fund performance to an index is the fund's management report of fund performance ("MRFP"). The Proposed Methodology requires that a fund with less than 10 years of performance history must select a reference index that "reasonably approximates the 'return on investment' of the fund" and provides some guidance on the selection criteria for the reference index. The Proposed Methodology requires that a brief description of any reference index used as proxy be disclosed in the simplified prospectus. The sales communication requirements in National Instrument 81-102 *Investment Funds* ("NI 81-102") generally require that sales communications be consistent with the simplified prospectus, annual information form and Fund Facts. Accordingly, for any fund with less

than 10 years of history, any reference index used in sales communications would need to match the reference index disclosed in the simplified prospectus.

However, due to the differences in the index selection guidelines contained in Form 81-106F1 *Contents of Annual and Interim Management Report of Fund Performance* ("Form 81-106F1"), the reference index disclosed in the prospectus and used in sales communications may not match the benchmark index in the MRFP.

Section 4.3(2) of Form 81-106F1 requires that fund managers compare fund performance to the historical annual compound total returns or changes of:

- (a) one or more appropriate broad-based securities market indices; and
- (b) at the option of the fund, one or more non-securities indices or narrowly-based market indices that reflect the market sectors in which the fund invests.

Form 81-106F1 defines "appropriate broad-based securities market index" as an index that

- (a) is administered by an organization that is not affiliated with the any of the mutual fund, its manager, portfolio adviser or principal distributor, unless the index is widely recognized and used; and
- (b) has been adjusted by its administrator to reflect the reinvestment of dividends on securities in the index or interest on debt.


The definition in Form 81-106F1 to select a benchmark index for the MRFP is much less specific than the selection criteria set out in the Proposed Methodology to select the reference index and could lead to the use of two (or more) different indices in the various disclosure documents of the same fund. This inconsistency would be confusing to investors. Furthermore, attempting to make sales communications consistent with both the MRFP and the prospectus by reflecting both the MRFP benchmark and the 81-102 reference index would likely only compound investor confusion.

FTIC urges the CSA to revisit all index selection and disclosure requirements applicable to mutual funds and make them consistent with each other.

Thank you for your consideration of this submission. Please feel free to contact me at 416.957.6010 or my colleague, Ariane Farrell, at 416.957.6089 should you have any questions or wish to discuss our submission.

Yours truly,

**FRANKLIN TEMPLETON INVESTMENTS CORP.**

  
Brad Beuttenmiller  
Senior Associate General Counsel