



Canadian Foundation *for*  
Advancement *of* Investor Rights  
Fondation canadienne *pour* l'avancement  
*des* droits *des* investisseurs

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**RE: Request for Comment: CSA Mutual Fund Risk Classification Methodology**

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FAIR Canada is pleased to offer comments on the CSA Notice and Request for Comment regarding the proposed CSA mutual fund risk classification methodology for use in Fund Facts and ETF Facts (the "Notice").

FAIR Canada is a national, charitable organization dedicated to putting investors first. As a voice for Canadian investors, FAIR Canada is committed to advocating for stronger investor protections in securities regulation. Visit [www.faircanada.ca](http://www.faircanada.ca) for more information.

## 1. Executive Summary

- 1.1. FAIR Canada supports mandating a standardized methodology for the risk ratings of mutual funds and ETFs but believes that changes to the Proposed Methodology are necessary. Changes must ensure that investors (and advisors) are not misled about the risks of an investment fund before they decide to invest.
- 1.2. Given our understanding of what matters to investors and the document testing that was conducted with investors, changes are necessary.
- 1.3. FAIR Canada urges the CSA to live up to international best practices and principles with respect to disclosure of risk. We also make specific recommendations regarding other proposed changes to the Proposed Methodology.

1.4. Finally, we believe that summary documents should be expanded to other investment products such as structured products and alternative investment funds. Fund Facts risk disclosure should be designed now so as to take into account other investment products that should also be subject to summary disclosure, so that meaningful comparisons can be made.

## 2. FAIR Canada Supports the CSA in Mandating a Standardized Methodology for the Risk Rating

2.1. FAIR Canada continues to support the introduction of a CSA mandated risk classification methodology (the “Proposed Methodology”) rather than allowing each fund manager to have the discretion to use its own methodology for disclosure in Fund Facts. The use of a prescribed methodology is a step forward as it will allow for transparency<sup>1</sup>, consistency and the ability to compare products through Fund Facts.

2.2. If the Proposed Methodology is adopted as guidance rather than mandated, it may not facilitate comparability between funds.

## 3. The Proposed Disclosure for Risk is Incomplete – More than Volatility Risk Needs to be Disclosed on Fund Facts

3.1. There is broad agreement that investment risk is not confined or limited to volatility risk. Therefore, the “How risky is it?” section of Fund Facts should not be limited to describing volatility. If it does, it will seriously limit the usefulness of this document for those who use and rely on it - investors and their advisors/dealers. Moreover, to limit this section to volatility risk may also mislead investors and advisors/dealers as to the risks involved with investing in the fund.

3.2. IOSCO’s Sound Practices for Investment Risk Education Final Report defines “investment risk” to be “...the risk that an investment will not deliver the expected yield and/or lose value. This concept is applied broadly in the report and taken to include a variety of risks such as:

- Volatility risk;
- Capital risk;
- Liquidity risk;
- Inflation risk;
- Credit risk; and
- Interest rate risk.”<sup>2</sup>

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<sup>1</sup> As noted in CSA Notice 81-324, “In addition to consistency, we think that the use of a standard methodology will enhance transparency in the market by enabling third parties to independently verify the risk rating disclosure of a mutual fund in the Fund Facts”; CSA Notice 81-324 (2013), 36 OSCB 11849 at 11850, available online at [https://www.osc.gov.on.ca/documents/en/Securities-Category8/csa\\_20131212\\_81-324\\_rfc-mutual-fund-risk.pdf](https://www.osc.gov.on.ca/documents/en/Securities-Category8/csa_20131212_81-324_rfc-mutual-fund-risk.pdf)

<sup>2</sup> IOSCO’s Sound Practices for Investment Risk Education Final Report, (September 2015), at page 3; available online at <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD505.pdf>.

- 3.3. FAIR Canada is of the view that disclosing only one type of risk in Fund Facts is flawed. The CSA has not provided an adequate explanation for why it would not follow the principles and best practices of the International Organization of Securities Commissions (“IOSCO”), including IOSCO’s Principle 1<sup>3</sup>, which requires that “[r]isk disclosures should include the material risks for the product”. If a scale is considered appropriate to identify the overall risk measurement or classification of the product, then this needs to be supplemented by: (a) a narrative explanation of the indicator and its main limitations; and (b) a narrative explanation of risks which are materially relevant.... and which are not adequately captured by the synthetic indicator.<sup>4</sup>
- 3.4. At present, the Proposed Methodology would result in the presentation of a graph in Fund Facts where the volatility risk falls within one of five categories (low, low-to-medium, medium, medium-to-high, and high) and provides a narrative explanation for the indicator (i.e., volatility risk) as follows:

“One way to gauge risk is to look at how much a fund’s returns change over time. This is called “volatility”. In general, funds with higher volatility will have returns that change more over time. They typically have a greater chance of losing money and may have a greater chance of higher returns. Funds with lower volatility tend to have returns that change less over time. They typically have lower returns and may have a lower chance of losing money.”

No narrative explanation of the indicator’s limitations accompanies this statement, nor does it set out or explain risks which are *materially relevant but are not adequately captured by volatility risk (the indicator)*. It just refers readers to the simplified prospectus if they want more information:

“For more information about the risk rating and specific risks that can affect the fund’s returns, see the Risk section of the fund’s simplified prospectus”.

The Fund Facts does not tell readers that volatility risk *does not take into account or adequately take into account other risks that are present* when investing in the fund (or, if volatility risk does take those other risks into account, the document does not indicate that it does so). Therefore, the risk section of Fund Facts is inadequate and misleading.

- 3.5. The template for the Key Investor Information Document<sup>5</sup> (or “KIID”) contained in the Committee of European Securities Regulators (CESR), now the European Securities and Markets Authority (ESMA), does have a narrative explanation of the indicator and its main limitations. The rating is on a scale of 1 to 7 rather than 5 as is now proposed by the CSA (originally 6) and contains a section “Narrative explanation of the indicator and its main limitations” which includes an explanation of “Why the fund is in its specific category” and that “The lowest category does not mean ‘risk free’”.
- 3.6. The KIID also includes a narrative explanation of the risks which are materially relevant and

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<sup>3</sup> IOSCO Principles on Point of Sale Disclosure, Final Report, (February 2011), at page 28.

<sup>4</sup> IOSCO Principles on Point of Sale Disclosure, Final Report, February 2011 at page 28, and at footnote 31.

<sup>5</sup> CESR’s template for the Key Investor Information Document (July 20, 2010); available online at: [https://www.esma.europa.eu/sites/default/files/library/2015/11/10\\_794.pdf](https://www.esma.europa.eu/sites/default/files/library/2015/11/10_794.pdf).

which are not adequately captured by the synthetic indicator. It has a “narrative presentation of risks materially relevant to the fund which are not adequately captured by the indicator.”

3.7. In order for investors to make informed investment decisions, in order to assist advisors help explain the material risks of the fund to their clients and in order to not mislead investors and advisors, it is necessary that the “How Risky is it?” section of the Fund Facts indicate the volatility risk of the fund in a way that is comparable to other funds *while also providing (a) a narrative explanation of the limitations of the volatility indicator and (b) the material risks of the fund not captured by volatility risk.*

3.8. **FAIR Canada strongly recommends that the “How Risky Is it?” section of Fund Facts must include more than volatility risk so that investors can understand the risks associated with the fund. This is essential in order to properly compare funds (which one needs to do) in order to make an informed investment decision. Investors must know the limitations of the indicator (the scale used) and be provided with a description of the material risks not adequately captured by the indicator. Investors in Europe are provided with this information in the KIID. Why would we not adhere to this international best practice and standard in Canada?**

#### 4. Investor Testing and Investor Behaviour Supports Including Material Risks in Addition to Volatility Risk

4.1. The CSA sponsored document testing with investors of the Fund Facts document in 2012. The testing was done with a version of Fund Facts that contained a list of “other specific risks” – a proposed requirement to list no more than four main risks of the fund. The quantitative research involved 532 online respondents across Canada from a random sample of 1603 Canadians. The quantitative testing found:

- Half (50%) of all mutual fund investors are not very or not at all clear about what other specific risks are.<sup>6</sup> The lack of understanding, not surprisingly, increases with a decrease in level of investment knowledge.
- 83% of the investors, nonetheless, wanted to keep the section “other specific risks” but have Fund Facts contain a brief explanation of each of the specific risks listed; 14% wanted to keep the “other specific risks” section just as it is while 3% wanted to drop the section.<sup>7</sup>
- The most frequently offered suggestion to improve the risk section of Fund Facts is to provide explanations of the other types of risks.<sup>8</sup>
- When asked to choose one or more actions they would take before purchasing the mutual fund (from a list of actions), 70% of investors said they would ask their advisor to explain the risk of the funds to them, 50% would read the simplified prospectus to learn about all

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<sup>6</sup> CSA Point of Sale Disclosure Project: Fund Facts Document Testing prepared by Allen Research Corporation (September 2012) at page 70; available online at [https://www.osc.gov.on.ca/documents/en/InvestmentFunds/pos\\_201209\\_fund-facts-doc-testing.pdf](https://www.osc.gov.on.ca/documents/en/InvestmentFunds/pos_201209_fund-facts-doc-testing.pdf)

<sup>7</sup> CSA Point of Sale Disclosure Project: Fund Facts Document Testing at page 71.

<sup>8</sup> CSA Point of Sale Disclosure Project: Fund Facts Document Testing at page 74. 17% of investors offered this suggestion to improve this section.

of the risks of the fund, 34% would look for more information about mutual fund risks on the internet and 26% said they would only read this Fund Facts document carefully to learn as much as they need to know about this fund's risks.<sup>9</sup>

The qualitative testing of investors involved 21 one-on-one, in-depth, one hour interviews. Many of the investors invested through an advisor and a few did their own investing. The interviews elicited the following:

- Many learn about the investment vehicle and purchase it on the advice of their advisor in the same meeting. "The information their adviser gives them is paramount and trust is a key part of the decision process."<sup>10</sup>
- The risk section "seems cluttered, textually dense, and required repeated reading to understand".<sup>11</sup>
- The labels on the x-axis -typically lower returns and less chance of success" and "typically higher returns and greater chance of success" – were described as very clear.<sup>12</sup>
- Investors were frustrated by the lack of explanation of the specific risks and did not want to have to look up the meaning or go to the simplified prospectus to find out.<sup>13</sup>

4.2. FAIR Canada is of the view that these findings strongly support revising the "How risky is it?" section of Fund Facts. However, the changes the CSA made went in a direction opposite to what was learned from the testing of the document with investors. In particular, the CSA:

- Deleted the specific risks listed rather than provide a narrative explanation of the specific risks.
- The CSA changed the sentence: "For a full list of *this fund's risk factors and details about them* see the Risk section of the fund's simplified prospectus" to "For more information about the risk rating and *specific risks that can affect the fund's returns*, see the Risk section of the fund's simplified prospectus." (emphasis added)

4.3. Investors and their advisors are unlikely to go to the simplified prospectus because:

- There is no language in the "How risky is it? section of Fund Facts that alerts the investor or advisor to the fact that the risk section does not include other material risks not captured by volatility risk (the risk scale).
- Few investors read and understand the simplified prospectus, as the CSA has itself stated: "[w]e know that many investors do not use the information in the simplified prospectus

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<sup>9</sup> CSA Point of Sale Disclosure Project: Fund Facts Document Testing at page 72.

<sup>10</sup> CSA Point of Sale Disclosure Project: Fund Facts Document Testing at page 29. See also page 30 for specific comments which demonstrate high degree of reliance and trust on the advisor.

<sup>11</sup> CSA Point of Sale Disclosure Project: Fund Facts Document Testing at page 33.

<sup>12</sup> CSA Point of Sale Disclosure Project: Fund Facts Document Testing at page 37.

<sup>13</sup> CSA Point of Sale Disclosure Project: Fund Facts Document Testing at page 38.

because they have trouble finding and understanding the information they need.”<sup>14</sup>

- Investors also no longer receive a copy of the simplified prospectus when they invest in the fund. They have to ask separately for it.
  - Focus group testing found that many learn about the investment vehicle and purchase on the advice of their advisor in the same meeting. There will likely not be sufficient time to read through the list of risks in the simplified prospectus.
- 4.4. In addition, the simplified prospectus will not alert the investor or advisor to the key or material risks but will rather provide them with a long list of all possible risks associated with the investment.
- 4.5. Given that securities regulators would not provide a receipt for a simplified prospectus if it only included volatility risk and not other material risks, the Fund Facts should also not be limited to volatility risk.
- 4.6. In addition, the CSA removed the labels on the x-axis –“typically lower returns and less chance of success” and “typically higher returns and greater chance of success” and substituted more text to describe the graph despite investors finding this clear.
- 4.7. **FAIR Canada strongly recommends that the CSA properly account for the investor testing results and revise the “How risky is it?” section accordingly. The material risks not covered by volatility risk should be put in the section with a narrative explanation.** This is what is done in the KIID.
- 4.8. FAIR Canada also notes that, given existing technology, the Fund Facts could be designed so the narrative explanation of the material risks are found in embedded links. This could be done in a manner that provides a simple explanation or a more detailed and sophisticated explanation, available at the option of the specific individual or advisor.
- 4.9. Our concerns are not addressed by the CSA’s proposal to allow the use of discretion to classify a mutual fund at a higher investment risk level. The CSA has provided discretion to move the fund up the risk scale but not an obligation to do so. Moreover, while a higher risk level may better reflect the effect of “qualitative factors in addition to the quantitative calculation in determining the investment risk levels of mutual funds”<sup>15</sup>, a discretionary adjustment to a higher risk level, without narrative explanation for the adjustment, gives no information to investors and advisors about the material qualitative risks.
- 4.10. FAIR Canada finds it completely puzzling that the CSA’s response to the recommendation of adopting the best practice of the ESMA and the KIID is: “It should be noted that the European summary document and risk scale have significant differences compared to our summary

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<sup>14</sup> CSA Implementation of Stage 2 of Point of Sale Disclosure for Mutual Funds – Delivery of Fund Facts, (2013) 36 OSCB 6001 at page 6003.

<sup>15</sup> CSA Notice and Request for Comment – CSA Mutual Fund Risk Classification Methodology for use in Fund Facts and ETF Facts, (December 10, 2015), 38 OSCB 10307 at 10319, available online at: [https://www.osc.gov.on.ca/documents/en/Securities-Category8/ni\\_20151210\\_81-102\\_mutual-fund-risk-classification-methodology.pdf](https://www.osc.gov.on.ca/documents/en/Securities-Category8/ni_20151210_81-102_mutual-fund-risk-classification-methodology.pdf)

documents. In our view, the Proposed Methodology best reflects the reality of our mutual fund market which allows for comparability across mutual funds.”<sup>16</sup>

- 4.11. Europe has developed a regulatory regime that allows for key information documents to be provided not only for mutual funds and exchange traded funds, but also for other investment products including packaged investment products and insurance-based products such as structured products, and index-linked notes.<sup>17</sup>
- 4.12. The reality of the Canadian mutual fund market is that summary documents presently contain weak risk disclosures with no comparability since the fund manager is free to use whatever methodology they like. We refer you to letters to securities regulators mentioned in our previous submission.<sup>18</sup> It has been demonstrated that the IFIC methodology can be unreliable and inconsistent between funds that are otherwise very similar.<sup>19</sup> The CSA has undertaken significant analytical work and research (we commend the CSA for doing so) and could very easily reform its Proposed Methodology and the risk section to make it live up to international standards. We strongly urge the CSA to do so.

## 5. Risk of Loss of Capital Critically Important to Investors

- 5.1. Investors understand risk as the chance of losing money and want to know how much they stand to lose.<sup>20</sup> The strongest criterion for an investor deciding not to buy a particular investment “is simply the chances of losing money”.<sup>21</sup> This is reflected in IOSCO’s definition of investment risk at paragraph 3.2 above.
- 5.2. Accordingly, we agree with the OSC’s Investor Advisory Panel and Kenmar Associates that clear unambiguous disclosure of potential for loss is extremely important. Given the results of investor testing done in 2012, this should be found in the “How risky is it?” section rather than in the performance section.<sup>22</sup>
- 5.3. The time needed to recover from a loss, especially a large loss, is not covered in the Proposed

<sup>16</sup> CSA Notice and Request for Comment – CSA Mutual Fund Risk Classification Methodology for use in Fund Facts and ETF Facts at 10317.

<sup>17</sup> European Commission – Packaged retail and insurance-based investment products, available online at [http://ec.europa.eu/finance/finservices-retail/investment\\_products/index\\_en.htm](http://ec.europa.eu/finance/finservices-retail/investment_products/index_en.htm)

<sup>18</sup> See footnotes 6, 7 and 8 of our letter dated March 12, 2014, available online at <http://faircanada.ca/wp-content/uploads/2011/01/FAIR-Canada-comments-re-CSA-risk-classification-methodology-proposal.pdf>.

<sup>19</sup> See our letter dated March 12, 2014, supra note 18, at footnote 9.

<sup>20</sup> The criteria that drive mutual fund decisions are “How much the fund earned in the past”, followed by “Performance compared to similar investments” and then “Chances of losing money”; and the strongest criterion for deciding not to buy is “Chances of losing money”. See Investor Education Fund, *Investor behavior and beliefs: Advisor relationships and investor decision-making study*, written by The Brondesbury Group, Toronto, ON, 2012 at page 23.

<sup>21</sup> The criteria that drives mutual fund decisions is How much the fund earned in the past, followed by Performance compared to similar investments and then Chances of losing money and the strongest criterion for deciding not to buy is Chances of losing money. See Investor Education Fund, *Investor behavior and beliefs: Advisor relationships and investor decision-making study*, written by The Brondesbury Group, 2012 at page 23; available online at <http://www.getsmarteraboutmoney.ca/en/research/Our-research/Documents/2012%20IEF%20Adviser%20relationships%20and%20investor%20decision-making%20study%20FINAL.pdf>.

<sup>22</sup> The investor testing of the Fund Facts in 2012 found that retail investors see the bar graph in performance section as showing performance only and not risk.

Methodology and needs to be conveyed to investors – otherwise there is a serious risk that investors may construe a one year gain of 30 percent as making up for a previous year's loss of 30 percent.

## 6. FAIR Canada Opposes the Five Category Scale

- 6.1. The CSA has made several changes to the Proposed Methodology based on industry comments (most notably, changing to a five category scale rather than six, changing the standard deviation ranges to be consistent with the IFIC methodology, removing the list of criteria for an index to be considered acceptable as a reference index while keeping the list of reference index principles, and changing the frequency of determining the investment risk level from monthly to upon filing the Fund Facts and at least annually thereafter).
- 6.2. We recommend that the six category-scale be retained and that it be conveyed numerically from 1 (lowest risk) to 6 (highest risk) so as to more appropriately categorize funds and allow for more differentiation in the indicator. This will also prevent investors and advisors from conflating the investor's risk tolerance with the risk rating of an investment product. The fact that keeping the same number of categories is more convenient to the industry and avoids imposing some costs should not be a deciding factor. We see our recommendation to change it to a numerical scale from one to six as also being advantageous in decreasing the risk of mis-selling as there will no longer be the possibility of equating the risk category with an investor's risk tolerance. A person, for example, who has a "medium" risk tolerance, should not necessarily purchase a mutual fund with a "medium" volatility risk. This over-simplifies the know-your-client process and is an issue that needs to be addressed. It also does not accord with modern portfolio theory where an investor's objectives and risk tolerance should be reflected in the overall mix of products in their portfolio, not in each particular investment contained within the portfolio.

## 7. Frequency for Reviewing Risk Level of a Fund

- 7.1. If a minimum annual frequency will be required for reviewing each fund's investment risk level, the CSA should provide clear criteria for when it is appropriate (and necessary) to do this more frequently.

## 8. Investments other than Mutual Funds and Exchange Traded Funds

- 8.1. FAIR Canada is strongly of the view that summary documents of key information necessary to make an informed investment decision are needed for other products in addition to mutual funds and ETFs. We urge securities regulators to produce such documents for structured products such as principal at risk notes, alternative investment funds, and closed end funds. We urge other regulators – for banking products and insurance products – to also do so.
- 8.2. We also strongly are of the view that Fund Facts summary documents need be provided to retail investors before the decision to invest is made.
- 8.3. FAIR Canada believes that the Proposed Methodology for mutual funds and ETFs should be designed with all investment products in mind so that when all products have summary documents, it will be possible for investors to use them to compare different types of



products, to the extent possible. Obviously a “one size fits all” approach will not suffice and some flexibility will be required, but one thing is clear – volatility risk alone will not suffice.

We urge the CSA to consider our comments. If disclosure of important information is incomplete or inaccurate this may lead to investors being harmed - the investor or their advisor may rely on it to their detriment and there will be a mis-match between the risk appropriate to the investor and the risk of the product. Such harm will decrease investor confidence in the financial services industry.

We thank you for the opportunity to provide our comments and views in this submission. We welcome its public posting and would be pleased to discuss this letter with you at your convenience. Feel free to contact Neil Gross at 416-214-3408/[neil.gross@faircanada.ca](mailto:neil.gross@faircanada.ca) or Marian Passmore at 416-214-3441/[marian.passmore@faircanada.ca](mailto:marian.passmore@faircanada.ca).

Sincerely,



Canadian Foundation for Advancement of Investor Rights

CC: British Columbia Securities Commission  
Alberta Securities Commission  
Saskatchewan Financial Services Commission  
Manitoba Securities Commission  
Ontario Securities Commission  
Autorité des marchés financiers  
New Brunswick Securities Commission  
Registrar of Securities, Prince Edward Island  
Nova Scotia Securities Commission  
Superintendent of Securities, Newfoundland and Labrador  
Superintendent of Securities, Northwest Territories  
Superintendent of Securities, Yukon Territory  
Superintendent of Securities, Nunavut