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Comments on:

CSA Notice and Request for Comment

Implementation of Stage 2 of Point of Sale disclosure for Mutual Funds

Proposed Amendments to National Instrument 81-101 Mutual Fund Prospectus Disclosure, Form 81-101F3 and Companion Policy 81-101CP Mutual Fund Prospectus Disclosure and Consequential Amendments (2nd Publication) June 21, 2012

Thank you for the opportunity to respond to the CSA Notice and Request for Comment. It is good to see the CSA responding positively to input and feedback from mutual fund industry practitioners and interested stakeholders including investor advocates.

My comments relate primarily to risk disclosure in the Fund Facts document, and I believe that Canada has the opportunity to establish a 'best of breed' model for the Canadian mutual fund industry by learning from the experiences of other countries.

In Japan, the financial regulator is currently in the process of considering making changes to the laws governing investment trusts (mutual funds). As part of this process a working group was established that is considering, among various items, potential changes to disclosure documents including the presentation of investment risk. I have been able to contribute directly to this process by providing input based on a detailed investigation I undertook of the changes implemented in Europe with UCITS IV. I have also followed the debate as it has unfolded in Canada. It is from this international perspective that I make the following comments for your consideration.[1]

[1] The views and opinions expressed herein are those of the author and do not necessarily reflect those of his employer, its affiliates, or employees.

It is best not to leave the risk rating methodology up to the fund companies

There are obvious benefits to allowing fund companies the discretion to self-select risk ratings that most closely correspond to internal risk models. However fund companies will always face commercial and competitive pressure to subjectively select a risk rating with an eye to marketing. Whereas reputable fund companies are likely to select the risk rating with regards to model accuracy and investor interests, there is still a significant opportunity for divergence, and the resulting lack of comparability has the potential to engender mistrust.

Japan's Experience

Prior to 2000, Japan allowed mutual fund companies to present their own risk rating, but this was later rescinded due to concerns when it was found that ratings differed for ostensibly similar funds.

Establish a transparent process for setting the rating methodology

In Europe, the methodological elements for the computation of the 'Synthetic Risk and Return Indicator' (SRRI) were published publicly in consultation papers, technical advisories, etc. The Committee of European Securities Regulators (CESR), tasked by the EU to develop the risk indicator, went so far as to say: "It is not possible to consult on the question of whether the SRRI should be used without also presenting the details of the proposed underlying methodology."[2]

As a result of the transparency of the European methodology, it is possible for interested third parties (even individuals with a spreadsheet and access to historic fund data) to calculate the SRRI for most European UCITS (mutual funds). Third-party verification of the SRRI provides a second opinion on the risk rating published by the fund companies. We have even been able to apply the SRRI methodology to the Japanese mutual fund data and compared results. Furthermore, in Europe some third-party data aggregators and service providers (such as Morningstar) are able to independently calculate the SRRI for funds and provide this information to customers.

In contrast, the best information I have about the Canadian IFIC risk methodology is the information noted tangentially in the 'comments' column of your recent "Request for Comments" document.

Don't claim more than the underlying model can deliver

"The risk scale is intended to show market risk and the relationship between risk and losses"

Are both returns and volatility incorporated in the methodology used to calculate the risk indicator? If the methodology simply calculates volatility, as is the case with the SRRI, then the risk rating is merely a volatility index. If that is the case, the risk rating does not explain the relationship between risk and returns (in general) or risk and negative returns = losses specifically (why losses?). To claim so is potentially misleading. As it is, you are simply stating that there is some correlation between volatility and average returns, but the indicator

[2] Consultation Paper: "CESR's technical advice at level 2 on the format and content of Key Information Document disclosures for UCITS", July 8, 2009, p. 6.

itself is not providing proof of this relationship.

When I reviewed the wording you propose in the sample Fund Facts document, I am also concerned about the phrase: *"The scale ranges… based on <u>how the fund is invested</u>, and <u>the level of risk and return</u> involved."* Does the scale really range based on how the fund is invested? How is the 'how' of investing captured in the scale? How do you define 'how' in this context? I think I know what you are trying to say but this is somewhat confusing.

On inclusion of a list of the fund's three to four main risks

I would not expect the brief list of key risks alone to provide meaningful decision information on the face of the Fund Facts document. The best result is that it will hopefully stimulate the conversation between the advisor and investor regarding the nature of those risks.

The explicit tie-in to a more detailed discussion of those risks in the SP is a good idea, but I am doubtful as to how much benefit will be derived from this by investors (especially given that they don't read the SP). I would expect that improving the ability of advisors to explain the nature of these risks would be the best chance for investors to improve their understanding.

Having reviewed some of the risk narratives included in European Key Investor Information Disclosure (KIID) documents, I would be inclined to say that not including a detailed risk narrative in Fund Facts is probably the right way to go.

On showing the worst 3-month return

Providing visual information that illustrates the historical realization of capital loss or downside risk is very valuable information for an investor. This information is likely to be more meaningful for an investor than the risk indicator itself as it corresponds more closely with risk as perceived by investors than volatility.

But hope springs eternal: don't just leave the investors at the bottom. How about showing the rate of recovery from lows as well?

On developing a CSA risk methodology

Canada has the opportunity to establish a 'best of breed' model for the Canadian mutual fund industry while learning from the experiences of other countries. In Europe, one of the key drivers is increased integration of the financial markets and reduction of cross-border barriers to financial services, and in this context the EU's harmonized solution may not be optimal for individual countries. Indeed, the risk metrics developed in various European countries prior to UCITS IV and SRRI show evidence of significant innovation and should be a valuable reference.

Consider for example some of the goals set for the GUISE risk indicator implemented in the Netherlands prior to imposition of the SRRI:[3]

> *"The most important condition was that the risk indicator had to provide for the consumer's needs and risk perception."*
>
> *"The approach chosen must minimize the possibility of the risk indicator giving the consumer incorrect expectations about the financial risks attached to the product."*
>
> *"Consumers associate risk primarily with the possibility of losing some or all of their deposit."*
>
> *"[GUISE] represents the expected payment that a consumer receives if the prices of an investment develop unfavorably."*

Whereas the stability over time was a key benefit of volatility as a metric used as the basis for the SRRI, the Netherland's example illustrates a significantly different set of priorities for risk disclosure design. My point here is not to promote GUISE but to emphasize that a theoretically rigorous approach can be successfully wedded to investor risk perception to create an effective risk indicator.

Feedback from the front lines in Europe: It's too early to tell

It is too early to tell whether the European experiment with the SRRI will be successful.

The Key Investor Information Disclosure (KIID) document carrying the SRRI has only recently started arriving in the inboxes and mailboxes of European investors, and as such it is too early to tell with certainty what the effect of the SRRI will have on investors and the industry.

Based on an investigation that I undertook recently in the UK, the initial response from self-directed investors and independent financial advisors has been predominantly negative towards the KIID and SRRI. Some of this negative response is likely a reaction to something new and not yet well understood. Nonetheless, it appears to me that the SRRI has provided an effective vehicle for comparing the volatility of mutual funds across Europe, in a way that was not previously done, and the introduction of this new information to the market has clearly stimulated the debate.

We will probably have to wait a couple of years for the EU to complete its first official review, nevertheless I believe some key issues can be gleaned from the ongoing debate.

Some key issues

Presentation is very important - It is very hard (some would say impossible) to shoe-horn the complex issue of risk into a simple risk metric and ranking model.

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[3] "A quantitative risk indicator for financial products", AFM - The Netherlands Authority for the Financial Markets, 2006

The warning you propose: *"Before you invest in any fund, you should consider how it would work with your other investment and your tolerance for risk"* makes valid and important points. But unfortunately the statement probably leaves the average investor wondering just how the fund will "work with other investments" and how the risk disclosure relates meaningfully to "your tolerance for risk".

1) *Correspondence between the risk metric used and investor risk perception and appetite*

It is important to minimize the distance between risk as generally perceived by investors and the risk disclosure form and methodology. While a sound theoretical basis for risk is clearly necessary, an academic model of risk is probably not suitable.

If this is not achieved, there will be cognitive dissonance and the risk metric will be misunderstood or rejected. There is some evidence of cognitive dissonance in Canada as evidenced by reportage in the media. My investigations show that German distributors are similarly challenged to explain to investors why their SRRI risk profiles have shifted strongly to the 'Risky' end of the scale as a result of the continuing European financial crisis.

When evaluating the risk disclosure methodology, it is crucial to ask how the presentation of risk relates to an investor's perception of risk:

#1 Fear of capital loss
#2 Fear of not achieving financial objectives
#3 Regret (for not achieving aspiration goals or hope)

How well does Volatility as a risk metric relate to the typical risk perception noted above? Not very well. However there are risk metrics that more closely aligned to what the average investor considers as risk, and these should be seriously considered. In particular, there are models and metrics that emphasize downside risk for which investors may show more affinity towards than volatility (which will need to be explained to each investor).

2) *Suitability of the risk metric as a tool used at the point of sale to stimulate a considered discussion of investment and portfolio risk.*

It is important to evaluate how risk is currently being presented to clients by advisors, and how the risk metric introduced will fit into the conversation.

3) *Suitability of the risk metric as an input to building a client's portfolio*

Some financial advisors have access to sophisticated tools to assist their clients build investment portfolios. Whereas the SRRI is based on volatility, it is not clear how SRRI can be used by advisors to help their clients build efficient portfolios. Currently, SRRI remains incompatible with the tools and risk metrics already in use for asset allocation and portfolio modeling, and as such is seen to be superfluous and potentially misleading information by financial advisors.

There is concern that the risk metric will be used to evaluate the investment in a one-off fashion without regard to its effect on the client's overall investment portfolio. (I assume that very few investors maintain mental models of their investments that account for covariances...)

On Focus Testing

It is very good to hear that you are considering undertaking investor testing of the risk disclosure. I would recommend that you not overlook incorporating advisor testing in your model as well. Effectively engaging the advisory layer is critical to improving investor understanding of investment risk.

There appears to be a significant body of knowledge established through investor testing in both North America and Europe. However, the testing, separated in time and geography and intent, is not always focused on the same objectives and my overall impression is that the right questions have not always been asked. This is an important thing to get right and I encourage you to take the time to set up an effective testing approach.

On Trailing Commissions

The sample Fund Facts document includes the following sentence:

> *"These trailing commission payments may create a conflict of interest by influencing the dealer or its representatives to recommend the fund over another investment."*

I believe that the more generic statement that "Commission payments may create a conflict of interest" would be better. Any commission structure will affect incentives, and the potential for conflict of interest is not inherent in the Trailing commission itself. Trailing commissions have the benefit of providing an incentive to advisors to encourage investors to stay put, and this stickiness is probably valuable to the industry in stressed situations. (As you are surely familiar, churn is a well-known problem when sales commissions dominate.)

Thank you again for the opportunity to contribute, and I would be pleased to entertain any questions.

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