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The Manitoba Securities Commission
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Nova Scotia Securities Commission
Superintendent of Securities, Newfoundland and Labrador
Registrar of Securities, Northwest Territories
Superintendent of Securities, Yukon Territory
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Dear Sirs/Mesdames:

Re: CSA Notice 81-324 and Request for Comments *Proposed CSA Mutual Fund Risk Classification Methodology for Use in Fund Facts* – published for comment December 12, 2013

We are pleased to provide the members of the Canadian Securities Administrators (CSA) with comments on the proposed CSA risk classification methodology which is described in the above-noted CSA Notice. Our comments are those of individual lawyers in the Investment Management practice group of Borden Ladner Gervais LLP and do not necessarily represent the views of BLG, other BLG lawyers or our clients.

Overall, we understand the policy rationale that would lead the CSA to consider mandating one standardized method for disclosing the risks associated with mutual funds. While we have no particular expertise on the specifics of the various different methodologies, we understand that

standard deviation is generally considered to be a good proxy for measuring the volatility of a mutual fund, which may be perceived of as "risk" – and we support the concept of the CSA choosing this one methodology and requiring all mutual funds to base their risk assessment on that measurement methodology (although we note that some mutual funds and their managers may wish to use a different methodology than one that measures "volatility" having regard to the specialized nature of the mutual fund – please see our comment 7 below).

However, we completely agree with the many industry participants who we understand will be urging the CSA to make rules in this area that are consistent with the guidelines established by The Investment Funds Institute of Canada (the IFIC Guidelines), which are widely used by industry participants. We consider that since the IFIC Guidelines also use standard deviation as the risk measurement, and have been widely used for many years within the industry without any regulatory comment or issue[1], the IFIC Guidelines have well served fund managers, dealers and investors in mutual funds to better portray and understand the risk (in terms of volatility) of mutual funds. If the CSA is unwilling to mandate the use of the IFIC Guidelines, then we urge the CSA to explain the issues they perceive with the IFIC Guidelines and continue to work with IFIC and other industry participants, so that the consultation can be informed, transparent and collaborative.

We have the following issues with the CSA's proposals.

Impact of the New Proposed Risk Scales

1. We urge the CSA to reconsider the proposed revamping of the risk scale that mutual funds will be required to use to portray their volatility. We understand that many mutual funds will have to reclassify their risk at a *higher* level than what they show today, simply because the CSA will have changed the risk scale, even though the actual risk of the mutual fund has not changed at all. The CSA acknowledge that they expect this will be the case, but we consider the CSA have completely discounted or underestimated the unnecessary disruption to both the industry and the investors in mutual funds that the revamped risk scale would entail, as well as the impact of a perception of a change in risk that would result for a majority of Canadian mutual funds.

   This change is not well explained – in that the CSA do not provide any meaningful rationale as to why this new risk scale is "better" than the current scale, which we find very curious, given that it was the CSA that developed the current risk scale (mandated in conjunction with the Fund Facts regime introduced in January 2011).

   The CSA hints at the reason for including a sixth risk band, without ever providing meaningful reasons for such a decision. We question the meaning of the CSA's explanation that the new risk bands will achieve "more meaningful volatility clustering in

[1] We note that some investor advocates and investor advocacy groups have been calling for more regulation in this area to ensure a standard methodology and disclosure.

the fund universe" and also ask how the new risk bands – including the new sixth band - achieve this?

We note that the new risk scale is inconsistent with National Instrument 81-101, which mandates disclosure in the Fund Facts using a five-point scale. It is confusing to us as to why the CSA did not propose using the same five-point scale, with their new proposed numerical bands, to support their previous decisions, which were tested extensively by the CSA on investors. This would appear to be in line with stakeholders' demands and comments (given the CSA's own testing). Keeping the scale to five categories would reduce the confusion and impact on investors, fund managers and dealers that we describe below.

Some of the fall-out of the proposed changed risk scale will include:

(a) The need for registered dealers and advisors to re-evaluate their clients' investments in mutual funds, given that the SRO suitability guidelines tie into the Fund Facts risk scale – that is, for example, a client who has been determined to have a "low risk" investment focus, should be invested primarily in "low risk" mutual funds. Not only will registered dealers and advisors be required to contact investors to explain this change and discuss how it impacts their account (which is particularly burdensome, since nothing has in reality changed), but clients will be asked to move their investments to a lower risk mutual fund(s) and/or to change their investment risk focus for their account. In addition, dealers will need to reassess their process for determining their clients' risk profile for appropriate compliance to ensure that the changes to the client's portfolio, or lack thereof, actually reflect what is warranted for each client. We also point out that "shifting" risks for mutual funds (movements between bands) will cause uncertainty and confusion for dealers and investors alike. All of this is understandably burdensome and unpalatable, particularly given the lack of any actual change. We urge the CSA to discuss the proposed methodology with the SROs – as well as representative groups of advisors and their compliance representatives - to come to a better understanding of how the proposed methodology may impact the distributors of mutual funds (and ultimately investors in mutual funds).

(b) Investors who indicate that they have a low or a medium risk investment focus for their accounts will be discouraged/not permitted to invest in equity-type mutual funds, including balanced funds, simply because these funds will have a higher risk as portrayed on the new risk scale. We consider that it is not in the best interests of Canadian investors to be so restricted, particularly given the traditional wisdom that equity investing, over the long term, derives better returns for investors. Having adequate resources for retirement and other financial needs is of utmost importance to Canadians, given the demographics of Canadian society, as well as the decreased access to pensions – whether private or public. This need has been demonstrated by recent provincial initiatives such as Quebec's Voluntary Retirement Savings Plan. We consider this to be a very important social issue, which cannot be ignored by the CSA and should be explored further – in

conjunction with the SROs and the various investor education organizations in Canada, along with industry groups.

(c) One way that dealers and advisors may wish to deal with the changed risk profiles of mutual funds, is to move clients into different mutual funds. If so, there will be costs associated with these movements – redemption fees/increased commissions, increased trading costs, adverse tax consequences – all of which will ultimately be borne by investors. Again we consider this to be a very important issue, which should not be ignored by the CSA.

(d) Many mutual funds will be required to show their risk at a higher risk level than they do presently. This could require wide-scale prospectus amendments, which are costly, confusing to investors and overall very burdensome to the industry (and ultimately cost investors in the mutual funds). Please see comment 2 below for our comments on transition to any new regime, which will minimize this disruption.

Need for Careful Consideration of Transition to Any New Regime

2. We urge the CSA to consider carefully – **and publish for comment** – proposed transition periods for any change of the nature contemplated in the CSA Notice. At the very least, any proposed transition must give mutual funds until their next prospectus renewal to make the changes contemplated by any final rules of this nature; and all mutual funds must have at least six months' notice of any transition. **When developing transition to any new rules, it is of utmost importance that the CSA keep in mind:**

(a) The work that is being done currently within the industry to revise the Fund Facts by May 13 (this proposed change would constitute the third time that Fund Facts have been revised since all mutual funds were required to have filed Fund Facts in July 2011). It is particularly burdensome for mutual funds and their managers to continuously revise the templates used to create Fund Facts, as well as for dealers and advisors to understand the changes made to the Fund Facts so they can use them with their clients and, we urge the CSA to give the industry – and investors - a period of at least two years without a revision to the form.

(b) The ongoing work within the industry to comply with CRM-2 requirements that came into force in July 2013. These requirements impact all registrants – including fund managers and distributors of mutual funds. Effective implementation of CRM-2 absolutely must take precedence to the CSA's efforts in this area, given the nature of the significant changes required by the CRM-2 requirements, as well as the continuing widespread uncertainty on many aspects on how to apply certain of the requirements and avoid unintended consequences. Any changes to risk classification for mutual funds can only be put in place (if indeed the CSA consider changes are necessary) at the earliest towards the end of 2016 or the beginning of 2017.

(c) We also point out that the recent choice of the CSA of mid-month dates, such as May 13 and June 13 (Fund Facts) and July 15 (CRM-2), has significant implications for industry participants and we urge the CSA to return to using calendar month-end dates, as well as dates that have a logical linkage to the new requirements and common industry timing, in order to ease transition.

Our emphasis on the need for an appropriate transition period, as well as an adequate period of time to review and comment on any proposed transition period is coloured by our recent experience with the amendments to the Fund Facts requirements that became effective in September 2013. We, together with our clients, were caught off guard as a result of the last publication of the final rules on the recent changes to the Fund Facts, since the CSA did not publish for comment the transition rules that all mutual funds file revised Fund Facts by May 13, 2014 and have them available for delivery by dealers by June 13, 2014. As we informed staff of the Ontario Securities Commission, this transition rule has created a very disproportionate burden on those fund managers who renew their prospectuses after May 13, 2014 but before September 1, 2014 (the Fund Facts amendments came into force in September 2013, which meant that fund managers that renewed prospectuses after that date were able to comply “early” with the new requirements), because they will be obliged to file two sets of Fund Facts, each with different data (necessitated because of the mid-month date chosen by the CSA). We were disappointed by the CSA staff’s overall negative reaction to our requests, which we made over the last year, that these burdens be alleviated for these fund managers and their funds. This will lead to increased costs to investors in the applicable mutual funds and to their fund managers.

Impact of the New Proposals on Continuous Disclosure

3. It is not clear to us what the CSA intend to do about changes to the continuous disclosure regime for mutual funds, if this risk classification methodology were to come into force. We urge the CSA to consider that the purpose of the Fund Facts is to communicate information about a mutual fund for *new* investors – any changes in risk classification should also be communicated to *existing* investors – perhaps by reference in the semi-annual and annual MRFPs required by NI 81-106. The CSA does not mention these disclosures in the CSA Notice and we believe this issue requires further thought and consideration.

Monitoring of Standard Deviation

4. We do not agree with the need for the monthly monitoring of standard deviation calculations for each mutual fund. We consider that this is quite unnecessary and provides no additional protections, given the CSA’s own expectation that mutual funds’ risks won’t change drastically from month to month (or even from year to year). The monthly monitoring requirement will mean that calculations must be conducted for each mutual fund, as well as compliance monitoring carried out to ensure these calculations are conducted and any changes in risk escalated as required to the appropriate bodies within the fund manager. An annual monitoring, in conjunction with the renewal of the mutual funds’ prospectus appears to us to be the maximum that should be mandated, with ad hoc

review in the discretion of the fund manager as a result of material changes to the fund that could impact its rating. This is consistent with current industry practice and the IFIC Guidelines and makes logical sense to us, given that the renewal must contain updated information about the mutual funds and all other information is updated annually.

We point out that this issue will be particularly acute for funds that may be close to the end of a risk band, such that it would not take much to slightly move the funds' standard deviation over the hurdle to the next risk band and then back again, or for a fund that experiences temporary volatility because of a specific strategy (for which, under the IFIC Guidelines, a fund manager could use its discretion to not disclose), thus necessitating material change reports, press releases and prospectus amendments for each change, together with potential impacts on whether or not existing investors are appropriately invested in those funds, given the suitability requirements of the SROs.

Fund managers should be given discretion to assess the types of "borderline" funds we refer to above, as they consider necessary. Please see our comment 6 below for our recommendations around the need for fund managers to retain discretion in assessing the volatility risk of mutual funds.

Reference Index for Mutual Funds with Less than 10 Year History

5. The CSA notice suggests that the proposed rules will provide guidance about the appropriate "reference index" to use if a mutual fund does not have a 10 year performance history. We believe that any proposed rules will require considerable refinement and we urge the CSA to consider the following issues, among others that may be raised by industry participants that are more familiar with the methodology to calculate standard deviation:

   (a) We consider that the fund manager should have discretion to choose a reference index that it considers appropriate – it is not necessary to mandate specifics around this issue, given the fund managers' overall fiduciary responsibilities. If the CSA feel they need to be prescriptive (and we recommend the CSA explain why there would be a need to be prescriptive), we question the CSA's statements in the notice about the reference index.

      (i) Why must the index be "widely recognized" – what does this mean in this context?

      (ii) How can the returns of an index be highly correlated to the returns of the mutual fund, when the mutual fund does not have any returns (a new fund) or does not have the returns for the same time periods as the index?

      (iii) How will a fund manager determine whether or not an index will have a "similar historic systemic risk profile" – what does this mean? And how will this apply to a new mutual fund?

   (b) We also point out that any CSA rule must permit a fund manager to use its discretion to use an appropriate reference index, even where a mutual fund has 10

years of performance data, in cases where there has been a fundamental change to the mutual fund and/or for any other reason the fund's past returns are not representative of the fund's current attributes.

Need to Allow for Fund Manager Discretion

6. The CSA's proposed methodology uses a quantitative process and does not permit any deviation, exercise of discretion or qualitative analysis by the fund manager. There may be many non-measureable risks, such as portfolio manager changes, relative liquidity of certain investments or a sector specific or global financial crisis. We believe that fund managers should be encouraged to apply discretion prudently, which we understand the CSA's proposals would not permit. In our experience fund managers are generally in the best position to assess non-measurable or unquantifiable risks and how they apply to a fund.

7. We urge the CSA to recognize that there may be speciality mutual funds for which standard deviation is not the correct measurement of risk – in that volatility is not the right measurement of risk to reflect the actual risk profile of the mutual funds. Precious metals mutual funds, including mutual funds that invest in gold, are the best example of this issue, given that the price of the underlying assets are inherently volatile. We recommend that further consultation be conducted and any proposed rules acknowledge the circumstances when a fund manager may wish to use another appropriate measurement of risk. At the very least, the rules should recognize the inapplicability of standard deviation to mutual funds that invest in precious metals and permit the fund manager to use a measurement that is more tailored to the specific mutual fund. We note that this result would be permitted by the IFIC Guidelines.

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Borden Ladner Gervais

We thank you for allowing us the opportunity to comment on the proposals set out in the CSA Notice. Please contact any of the following lawyers at the contact details provided below if the CSA members would like further elaboration of our comments. We, together with other BLG lawyers who have considered the proposals, would be pleased to meet with you at your convenience.

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Yours very truly,

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