NATIONAL BANK SECURITIES

March 12, 2014

BY ELECTRONIC MAIL: comments@osc.gov.on.ca, consultation-en-cours@lautorite.qc.ca

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 Territory
Superintendent of Securities, Nunavut

Attention:
The Secretary
Ontario Securities Commission
20 Queen Street West
22nd Floor, Box 55
Toronto, Ontario M5H 3S8

Me Anne-Marie Beaudoin
Corporate Secretary
Autorité des marchés financiers
800, square Victoria, 22nd floor
C.P. 246, Tour de la Bourse
Montréal, Québec H4Z 1G3

Dear Sirs and Mesdames:

RE: CSA Notice 81-324 and Request for Comments: Proposed Mutual Fund Risk Classification Methodology for Use in Fund Facts ("Proposed Methodology")

National Bank Securities Inc. ("NBS") and National Bank Financial ("NBF")(collectively, "we") appreciate the opportunity to comment on the Proposed Methodology. We are both investment fund managers as well as distributors of investment funds. NBS is an investment fund manager of 82 investment funds, representing assets under management of approximately $17 billion and employs approximately 3,000 mutual fund representatives throughout Canada.

NBF, an investment dealer with approximately 1000 representatives throughout Canada, offers a wide range of financial services and products, including investment funds, to its clients.

General Comments

As an investment fund manager, NBS currently uses the IFIC Voluntary Guidelines for Fund Managers Regarding Fund Volatility Risk Classification (the "IFIC Methodology") and has done so for many years. The IFIC Methodology is clear, easily understood by investors and used by the majority of Canadian investment fund managers.

We strongly believe risk classification is a market activity that should remain an activity of the industry. Therefore, we are of the opinion that the CSA should adopt high level principle-based guidance with respect to risk classification rather than mandate the Proposed Methodology.

Please see below our comments regarding certain objectives of the Proposed Methodology:

Objective: The Proposed Methodology should be a uniform methodology applicable to all investment funds

We agree with the CSA's objective to have a uniform methodology applicable to all investment funds. The IFIC Methodology has been used for many years and considerable efforts have been made by the industry to educate investors regarding risk classification. We recommend that the CSA improve the IFIC Methodology, rather than mandate the Proposed Methodology which will create investor confusion and require additional implementation costs.

Objective: The Proposed Methodology should be easy to understand by all market participants

The IFIC Methodology is widely used by investment fund managers and is well understood by market participants.

The Proposed Methodology uses similar labels as the IFIC Methodology, however these labels are associated with different risk categories. Implementing the Proposed Methodology would create investor confusion as certain investment funds will have to be re-labeled with a different risk classification despite the fact that the risk will have essentially remained unchanged.

An unintended consequence of this possible confusion is that investors may reduce their equity allocations in their investment portfolios. The long-term performance of investors may suffer as an important number of investors may switch to investment funds that appear less risky.

Objective: The Proposed Methodology should be meaningful and allow for easy comparison across investment funds

We believe that the IFIC Methodology allows for an easy comparison across investment funds.

Risk classification is only meaningful if investment fund managers can also apply qualitative factors to quantitative measures in order to ensure full, true and plain disclosure. Investment fund managers must retain their discretionary power to classify an investment fund either higher or lower than the risk classification indicated by a strict application of the IFIC Methodology.

Removing the discretion of investment fund managers to apply qualitative factors in determining the risk classification of an investment fund may result in risk classifications being less accurate.

NBS has often been conservative in the use of this discretion. For example, even when a « Medium-to-High » risk classification was appropriate based on quantitative results, a « High » classification may have been given when sector and geographic concentrations factors were taken into account.

Objective: The Proposed Methodology should be relatively simple and cost-effective for investment fund managers to implement

NBS has invested a great deal of time to create and implement internal processes and money to update its systems to ensure that the IFIC Methodology is applied thoroughly to its investment funds.

The implementation of the Proposed Methodology will lead to approximately **80%** of NBS' investment funds being re-labeled with an apparent higher risk classification (without any associated change in the investment fund's actual risk). It seems fair to believe that such a major change to NBS investment funds' classification would be neither simple nor cost-effective.

Such re-labeling of the risk classification will also have a significant impact on both NBS' and NBF's distribution activities as clients' files may have to be updated to ensure that the re-labeled investment can still be considered suitable for the investor under SRO rules.

We believe that such re-labeling will be extremely confusing for all stakeholders, especially investors.

Conclusion

We would like to thank you for providing us with an opportunity to comment on this important issue. We look forward to our continued participation in any further public consultation on this topic and would be pleased to discuss our input in greater detail with you. We have expressed our main concerns and our objective is to find solutions that are relevant for, and serve the needs of the Canadian market. We are willing to take a leadership role in this issue by participating in consultations with investors, industry participants and the CSA.

Yours truly,

Michel Falk

Michel Falk
President and CEO of National Bank Securities Inc. and National Bank Trust,
Senior Vice-President, Investment Solutions and Trust Services

Attachment:
Appendix A: Reponses to Issues for Comment

APPENDIX A

CSA Notice 81-324 and Request for Comment: Proposed CSA Mutual Fund Risk Classification Methodology for Use in Fund Facts[1]

1. As a threshold question, should the CSA proceed with (i) mandating the Proposed Methodology or (ii) adopting the Proposed Methodology only as guidance for fund managers to identify the mutual fund's risk level on the prescribed scale in the Fund Facts? Are there other means of achieving the same objective than by mandating the Proposed Methodology, or by adopting it only as guidance? We request feedback from investment fund managers and dealers on what a reasonable transition period would be for this.

As mentioned in our letter, we believe that the CSA should adopt high level principle-based guidance with respect to risk classification rather than mandate the Proposed Methodology.

The IFIC Methodology is widely used by the vast majority of the industry and is easily understood by investors. In order to minimize any impact on investors, the IFIC Methodology should be maintained, with modifications, as needed.

We believe a reasonable transition period would be at least one (1) to two (2) years. The transition period must cover all the different Fund Facts renewal dates.

3. We seek feedback on whether you agree or disagree with our perspective of the benefits of having a standard methodology, as well as whether you agree or disagree with our perspective on the cost of implementing the Proposed Methodology.

We agree with the CSA's perspective on the benefits of having a standard methodology as it will provide consistency and transparency of disclosure and improved comparability of different investment funds.

The costs associated with the implementation of the Proposed Methodology would **not** be minimal. NBS estimates that **80%** of our investment funds would move to a higher risk classification under the Proposed Methodology. The dealer and investor impact of the proposed risk band changes will be significant. Moving investment funds to a higher risk classification may result in many investor accounts that are currently considered suitable to become unsuitable. This will create a burdensome process for NBS and NBF as we will need to review thousands of accounts and meet with thousands of investors to ensure ongoing suitability.

4. We do not currently propose to allow fund managers discretion to override the quantitative calculation for risk classification purposes. Do you agree with this approach? Should we allow discretion for fund managers to move their risk classification higher only?

Other types of risk, both measurable and non-measurable, may exist. We believe investment fund managers must retain their discretionary power to classify an investment fund either higher or lower than the risk classification indicated by quantitative results. Doing so allows an investment fund manager to make a full, true and plain disclosure of all material facts relating to the investment funds being offered.

NBS has often been conservative in the use of this discretion. For example, even when a « Medium-to-High » risk classification was appropriate based on quantitative results, a « High » classification may have been given when sector and geographic concentrations factors were taken into account.

5. Keeping the criteria outlined in the introduction above in mind, would you recommend other risk indicators? If yes, please explain and supplement your recommendations with data/analysis wherever possible.

We believe that the standard deviation is the most appropriate measure of volatility.

---

[1] Please note that we have not provided comments for Questions 2 and 10.

6. We believe that standard deviation can be applied to a range of fund types (asset class exposures, fund structures, manager strategies, etc.). Keeping the criteria outlined in the introduction above in mind, would you recommend a different Volatility Risk measure for any specific fund products? Please supplement your recommendations with data/analysis wherever possible.

We believe that the standard deviation is the most appropriate measure of volatility.

7. We understand that it is industry practice (for investment fund managers and third party data providers) to use monthly returns to calculate standard deviation. Keeping the criteria outlined in the introduction above in mind, would you suggest that an alternative frequency be used? Please specifically state how a different frequency would improve fund risk disclosure and be of benefit to investors. Please supplement your recommendations with data/analysis wherever possible.

We agree that using the investment fund's monthly returns is appropriate.

8. Keeping the criteria outlined in the introduction above in mind, should we consider a different time period than the proposed 10 year period as the basis for risk rating disclosure? Please explain your reasoning and supplement your recommendations with data/analysis wherever possible.

Using a 10-year history to calculate the standard deviation for an investment fund may result in an investment fund being classified as more volatile than it actual is if there are two (2) volatile periods i.e at the beginning and at the end of the ten (10) years.

We believe that using three-to-five-year historical data would be the appropriate timeframe as this represents the average time that an investor holds securities of an investment fund. By using this timeframe, the calculation of the standard deviation represents the stability of the volatility risk of the investment fund over time.

9. Keeping the criteria outlined in the introduction above in mind, should we consider an alternative approach to the calculation by series/class? Please supplement your recommendations with data/analysis wherever possible.

We believe that the investment fund manager should use the total returns of the "oldest" investment fund series/classes as the basis for his/her volatility risk calculation across all the investment fund series/classes having the same strategy as the volatility risk remains the same. This is currently NBS' approach.

11. Keeping the criteria outlined in the introduction above in mind,
i. Do you agree with the proposed number of risk bands, the risk band break-points, and nomenclature used for risk band categories?
ii. Do the proposed break points allow for sufficient distinction between funds with varying asset class exposures/risk factors?
If not, please propose an alternative, and indicate why your proposal would be more meaningful to investors. Please supplement your recommendations with data/analysis wherever possible.

We believe that the Proposed Methodology's risk bands and associated labels will lead to a large number of investment funds being re-labeled with an apparent higher risk classification, without any associated change in the investment fund's risk. **80%** of NBS' investment funds would move upwards to a higher risk classification under the Proposed Methodology.

We do not believe that it is necessary to have a "Very High" classification as there are very few mutual funds which would be included in this band. We recommend that the CSA use the same number of risk bands and the same nomenclature as described in the IFIC Methodology.

12. Do you agree with the proposed process for monitoring risk ratings? Keeping the criteria outlined in the introduction above in mind, would you propose a different set of parameters or different frequency for monitoring risk rating changes? If yes, please explain your reasoning. Please supplement your recommendations with data/analysis wherever possible.

We believe that semi-annual monitoring of the investment fund risk would be appropriate as the approach in calculating the volatility of an investment fund needs to be highly stable.

We have concerns regarding the classification of "borderline" investment funds i.e. investment funds that have a volatility level that is very near the end of the range. We believe that a buffer zone of fifty (50) basis points should exist for "borderline" investment funds to allow the investment fund manager to have the discretion to retain the existing risk classification rather than move to a higher classification. This would be in line with the CSA's objective of stability in risk classification.

13. Is a 10 year record retention period too long? If yes, what period would you suggest instead and why?

Investment fund managers should retain documentation on standard deviation calculations for at least seven (7) years, which is consistent with the MFDA rules on the retention of documents.

14. Please comment on any transition issues that you think might arise as a result of risk classification changes that are likely to occur upon the initial application of the Proposed Methodology. How would fund managers and dealers propose to minimize the impact of these issues?

As noted in our response to Question 11, application of the Proposed Methodology would cause significant disruption to dealer firms and investors due to a large number of investment funds moving to higher risk classifications. As mentioned before, **80%** of NBS' investment funds would move upwards to a higher risk classification under the Proposed Methodology. This will create a burdensome process for NBS and NBF as we will need to review thousands of accounts and meet with thousands of investors to ensure ongoing suitability.