

March 12th 2014

BY ELECTRONIC MAIL: comments@osc.gov.on.ca consultation-encours@lautorite.qc.ca

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
Superintendent 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

The Secretary
Ontario Securities Commission
20 Queen Street West, Suite 1903, Box 55
Toronto, ON M5H 3S8

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

Dear Sirs / Mesdames:

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

The Federation of Mutual Fund Dealers (the "Federation") is an Association of Canadian mutual fund dealers and affiliates whose members, since 1996, have been working to be the voice of independent mutual fund dealers. We currently represent dealer firms with over \$114 billion of assets under administration and 17,000 licensed advisors that provide financial services to over 3.5 million

Canadians and their families. A list of our members can be found at www.fmfed.ca.

The Federation is writing to provide comments with respect to the above captioned Notice (the "Notice"). We appreciate the opportunity to comment and also appreciate the CSA's providing a 90 day comment period on this important issue.

As you point out in the Notice, the investment fund risk classification methodology developed by the Investment Funds Institute of Canada (IFIC) is the predominant risk classification methodology used today by fund managers. We would therefore suggest mandating that methodology as it would cause the least amount of disruption in the industry. This would provide the consistency you desire across the industry, would not affect the majority of mutual fund managers' processes, would not cause dealers to amend their know-your-client forms, would not trigger client's portfolios to be off-side their know your client criteria, and would not cause confusion on the part of clients.

We have several concerns regarding what is contemplated by the Notice which are outlined below.

1. The Notice does not establish how the current processes place investors at a disadvantage or where investors have been materially harmed. The Notice suggests that a change would improve transparency without establishing that currently transparency is lacking, and the Notice cites that a change would improve the ability for third parties to independently verify the rating disclosures. We can see where the proposals will make it easier for third parties by simplifying their calculations but in appeasing the third parties the changes do a disservice to the ultimate stakeholder, the investor.
2. We believe volatility, by itself, is an overly simplistic view of risk from a retail investor's perspective. We acknowledge that it is widely used by institutional investors but at the retail level it is inconsistent with research in behavioural finance. Retail investors perceive downside risk differently than upside gains and volatility does not distinguish between the two. For example, institutional investors understand and can react to Black Swans and 'long tails' but retail investors often do not. Adopting a one dimensional view of risk across the market does not meet the needs of all the constituents.
3. The use of a single time limited calculation causes a similar concern. A client's view of risk must be viewed in the context of the time horizon for their goal. Those goals can range from as much as 50 years for retirement to as little as a couple of months for shorter term expenditures. The use of a 10

year measure may not fit for either of those scenarios. For example, a 10 year horizon that crosses 1 or 2 economic cycles may be completely inappropriate for a short term investor who views their personal risk in the context of today's economic reality. By adopting a unilateral time frame for risk tolerance the CSA may be creating unintended and higher risk for many investors.

4. The one dimensional view of risk at the fund level runs contrary to Modern Portfolio Theory¹. Advisors and their clients optimize overall portfolio outcomes by combining investments that behave differently from each other, at different points in time. They determine the optimal risk profile on the basis of co-variance and not volatility. By focusing on the conformity of one measure of risk, the CSA compromises the overall architecture for prudent portfolio decisions. Fund managers by definition can operate at the fund mandate level (volatility) but advisors and their clients need to also operate at the portfolio level (diversification and co-variance).
5. We believe the CSA has grossly underestimated the cost of implementing the proposed change. Changing the risk rating for individual funds will require advisors to re-evaluate every portfolio they manage to ensure the client's trade suitability remains consistent with the new ratings. Where they differ, the advisor will be required to meet with the client, review their risk tolerance and adjust the portfolios. There will be increased cost in paper work, lost productivity, trading costs and fees — the majority of which will ultimately be borne by the investor. In recent discussions with our fund company members and other fund companies, they estimate that the impact of this proposed change will affect 90%+ of existing funds. This will directly impact the client and the suitability of the client's holdings, with, as we state above, no benefit to the client. Even if only 30% to 40% of client accounts require adjustments, with over 45,000,000 mutual fund accounts in Canada (IFIC Dec 31, 2012), this translates to tens of millions of account changes. The costs to dealers, advisors and their clients will be far from "minimal".
6. We would encourage the CSA, to address the cost/benefit of the proposal and suggested changes; how specifically will the proposals enhance investor outcomes?
7. We remain sensitive to the issue of product arbitrage and the application of new rules to only one subset of the investments available to Canadians. If the goal of the proposed changes is conformity, we fail to see how that goal is achieved unless it is applied as well to segregated funds, deposit products, exchange traded funds, etc. Failing to apply the proposed rules to all products

¹ A theory on how risk-averse investors can construct portfolios to optimize or maximize expected return based on a given level of market risk, emphasizing that risk is an inherent part of higher reward.

introduces another opportunity for dysfunctional product arbitrage and even less transparency.

8. The management of investment funds and client portfolios is a complex, dynamic process. By forcing participants to conform to one dimensional constructs, the CSA runs the risk of constraining flexibility and prudent judgement. We are concerned that some participants may begin to manage their mandates to fit the regulatory ratings rather than the broader investment objectives. Such unintended practices would not be in the best interest of investors or their advisors.
9. We are also concerned with the use of back filling with index data; OSC Staff Notice 33-729 discusses how inappropriate it is to use hypothetical back-tested data in sales communications for mutual funds, yet that is exactly what the proposed methodology supports and makes common practice. The end result will be funds that are available in trust and class versions that have different performance lengths and have different risk ratings purely because they have a greater proportion of history that is backfilled. If you examine funds where the fund version has a much lower standard deviation than the class version, purely due to launch date (say 2003 vs. 2008) we wonder how the CSA proposes to handle such incongruences without allowing fund manager discretion.
10. We also wonder how this proposal would impact Fund Facts and how the mandate for managers to use hypothetical data to estimate risk ratings is now in the client's best interests. Is this an ineffective means to justify an end?

Should you have any questions, do not hesitate to contact the undersigned.

Regards,

Federation of Mutual Fund Dealers



Sandra L. Kegie
Executive Director