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

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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
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Me Anne-Marie Beaudoin
Corporate Secretary
Autorité des marchés financiers
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Re: CSA Consultation Paper 81-324

We are writing to provide comments with respect to the CSA Consultation Paper 81-324: *Proposed CSA Mutual Fund Risk Classification Methodology for Use in Fund Facts.*

Quadrus Investment Services Ltd. ("Quadrus") is one of the largest mutual fund dealers in Canada with more than 3770 registered investment representatives. It is the exclusive mutual fund dealer for London Life Insurance Company and preferred mutual fund dealer for the Gold Key investment representatives of The Great-West Life Assurance Company.

We would like to thank the Canadian Securities Administrators (the CSA) for the opportunity to provide feedback on their *Proposed CSA Mutual Fund Risk Classification Methodology for Use in Fund Facts*. At Quadrus we believe that it is beneficial for Canadians to have all mutual funds evaluated on a consistent standard and so we applaud the CSA's consideration of mandating a uniform standard. We think it is most important that any move to a new standard risk rating process should minimize the impact on Canadian investors currently invested in mutual funds.

We agree that the predominant risk classification methodology used today by mutual fund managers in Canada is the Investment Funds Institute of Canada (IFIC) *Voluntary Guidelines for Fund Managers Regarding Fund Volatility Risk Classification*. We strongly recommend the CSA consider adopting the current IFIC *Guidelines* as the new mandatory standard. Such an approach would accomplish the CSA goal of ensuring a consistent evaluation of risk across all mutual funds in Canada. Importantly, it would achieve this goal without imposing changes to most existing fund ratings, and would therefore have a limited impact on existing Canadian investors.

It is our conservative estimation that well over 50% of the mutual funds in Canada will be rerated to a different risk classification using the CSA *Proposed Methodology*. This level of change will create significant implementation issues for mutual fund dealers and clients who made investment recommendations and decisions based on existing ratings.

Quadrus has a developed process that captures and communicates to our advisors mutual fund risk rating changes on a quarterly basis. This process ensures that advisors are aware of any changes to risk ratings on mutual funds which their clients invest in. Over the last 4 years the level of change on risk ratings on all of our funds has seen about 1% change in risk rating of all funds in any given quarter or roughly 4% of funds switching risk categories annually. Because of this, advisors are currently used to having conversations with about 1 in 25 clients about a mutual fund changing risk classifications in any given year.

In comparison, changing 50+% of the risk ratings on mutual funds in Canada at one time is equivalent to the aggregate of more than 12 normal years of change. The degree of change under the *Proposed Methodology* is further accentuated since there is a preponderance of fund rating changes to higher levels on the risk rating scale. The work involved in explaining these changes to affected clients should not be underestimated.

Historically, risk rating change discussions between advisors and Canadians have centred upon an actual change to the fund; a modification to the investment policy, a different management style being implemented, a change in the portfolio manager, a broadening of the investment opportunity set for the fund, etc. These discussions are well understood as there is a legitimate change to the risk attributes of the fund. The discussion required by the *CSA Proposed Methodology* will be different because the fund will not have changed. What has changed is the classification standard of the fund. This distinction may not be well understood by many Canadians. A fair and likely question will arise when the advisor mentions that the client's investments should be revisited as a result of the changes: "Why do I need to change anything when the fund is the same as it always has been?". The advisor made the recommendation originally based on the fund manager's previous assessment, which usually was based on the IFIC Standard. Recommendations made in good faith based on information provided by the fund manager could create communication difficulties for advisors and clients, and could lead to conflict.

To date the CSA has fostered a suitability framework through the interplay of Know Your Client and Know Your Product requirements which clients, advisors and the industry have come to understand and trust. Moving to a more conservative standard for Know Your Product requirements will create situations where investments that were considered to be suitable for a given client, no longer are. Advisors and clients will have to determine whether the client should sell out of the investment – potentially incurring taxable gains or losses or selling at an inopportune time – or change their suitability responses in order to maintain the investment that to date has been acceptable.

Recalibrating the Know Your Client requirements to better integrate with the *CSA Proposed Methodology* would require revisions to existing Self Regulatory Organization (SRO) rules. For example, the Mutual Fund Dealers Association Staff Notice MSN 0069, which has become well understood and adopted by firms and advisors, would require revision. The *CSA Proposed Methodology* would also require a change to the KYC framework endorsed by the SROs in order to avoid a general de-risking of investments for Canadians. Collectively, these two changes would be difficult to coordinate and result in an enormous undertaking with little apparent benefit to Canadians.

In closing, we provide two possible solutions for the CSA to consider that avoid such a dramatic upheaval to the suitability framework that Canadians have come to understand and trust.

Solution One

We recommend that the CSA impose risk classification standards that mirror the currently generally accepted guidelines set by the Investment Funds Institute of Canada (IFIC). This standard has already been adopted by most Canadian fund managers and is the natural starting point for any new mandatory standard. This approach will not suddenly create an apparent increase in risk to a large percentage of mutual funds and so avoids the issues that arise if the CSA's *Proposed Methodology* were implemented.

Solution Two

If there is some reason why the IFIC *Voluntary Guidelines* is not preferred, we recommend a change to the proposed risk categories. The CSA Proposal suggests the addition of a sixth risk category of "very high". We prefer the use of 5 risk categories rather than 6 for the simple reason that current inforce KYCs are based on 5 risk tolerance levels. Losing the symmetry between the KYC classification and the

Know Your Product risk rating from the Fund Facts will seem illogical and create confusion for Canadians and their advisors.

If the CSA feels strongly about the need to implement a sixth risk band, then we recommend the new category be reflected in the proposed lowest risk scale rather than at the higher end of the scale. As an example, consider the fact that a 4% level of risk represents double the amount of risk incurred when compared to a 2% level of risk as measured by standard deviation. This is very significant and much more important to distinguish than at the upper end of the risk scale where a jump from 28% to 30% represents only a 7% relative increase in risk incurred. For this reason we propose that the "Very" adjective be better employed at the low end of the scale and that the names be adjusted in the following way.

CSA Proposed Name	Quadrus Proposed Name	CSA Standard Deviation Bands
Low	Very Low	0% - 2%
Low to Medium	Low	2% - 6%
Medium	Low to Medium	6% - 12%
Medium to High	Medium	12% - 18%
High	Medium to High	18% - 28%
Very High	High	>= 28%

Although the lack of symmetry issue would still remain, renaming the bands in this manner significantly lessens the number of funds that will move to a higher risk category. This will lower the number of situations where a previously appropriate investment arbitrarily changes to an unsuitable one. For example, the IFIC Low to Medium band encompasses a 6%-11% range in standard deviation, while under the above proposal the range is 6%-12% which is very close. Similarly, for the Medium category, the current IFIC band is 11-16% while a revised CSA *Proposed Methodology* would see a range of 12-18% which again demonstrates considerable overlap.

Summary

The methodologies used to assess the risk rating of mutual funds by the CSA *Proposed Methodology* and the IFIC *Voluntary Guidelines* differ. We believe that either statistical approach could be used successfully and that a subjective discussion of the pros and cons of the two methods moves focus away from the more important goal of implementing a uniform standard in a manner that minimizes the impact on clients and advisors who have, in good faith, taken action based on the existing ratings. Any move to impose a standard should take the impact on clients into consideration, and attempt to minimize that impact. We also strongly believe that any move to a new, more conservative standard should include some form of safe harbour for recommendations made under the previous standards, and flexibility in dealing with implications for previously appropriate portfolios.

We very much thank the CSA for the opportunity to provide comment on this proposal.

Michael Stanley

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Quadrus Investment Services Ltd.