March 12, 2014

Delivered By Email: 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
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, 22e étage
C.P. 246, tour de la Bourse
Montréal (Québec) H4Z 1G3

Dear Sirs and Mesdames:

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

We are writing to provide you with comments on behalf of the Members of the Investment Funds Institute of Canada ("IFIC") with respect to the Canadian Securities Administrators' ("CSA") *Notice 81-324 and Request for Comment – Proposed CSA Mutual Fund Risk Classification Methodology for Use in Fund Facts* published on December 12, 2013. We appreciate the opportunity to participate in this discussion.

IFIC's Fund Risk Classification Task Force ("the Task Force") was established in 2003 and tasked with the development and ongoing revision of the IFIC Voluntary Guidelines for Fund Managers Regarding Fund Volatility Risk Classification (the "IFIC Methodology"). The IFIC Methodology is revised annually to ensure it evolves to meet the ongoing requirements of investors and the investment industry. A copy of the current version of the IFIC Methodology is attached to this letter.

For ten years, the IFIC Methodology has assisted fund managers regarding the classification and comparisons of the volatility risk associated with different types of mutual fund categories. The IFIC Methodology and guidelines are designed to assist with standardizing terminology, categories, and volatility risk descriptions of funds. We support and encourage these standard approaches.

The CSA Request for Comment poses a number of issues for comment – we provide our responses in Appendix A.

General Comments

Fund risk classification is a market activity that should remain an activity of the industry. Rather than issuing a Proposed Methodology, we firmly believe that it would be appropriate for the CSA to provide high-level principle-based direction with respect to fund risk classification, while the industry continues to develop, evolve, and administer the actual fund risk methodology.

We agree with the CSA's criteria and objectives as set out in Annex A of CSA Notice 81-324 and we believe these objectives should serve as a model for development of a principle-based approach.

We believe that the IFIC Methodology serves investors and the industry well and fully addresses and satisfies all of the objectives of the CSA, and does so in a more complete and effective manner than would the implementation of the Proposed Methodology. Our comments with regards to each CSA objective are elaborated upon below.

Principle 1: The methodology should be a uniform methodology applicable to all investment funds

The IFIC Methodology is currently used for the vast majority of investment funds and can be uniformly applied to all investment funds. Although the IFIC Methodology was developed for IFIC members, we support making it publicly available for use by non-members as well.

Principle 2: The Methodology should be easy to understand by all market participants

The IFIC Methodology has been in use for many years and is well understood by market participants. It has a volatility measure based on standard deviation which is the most widely accepted and easily understood measure of fund volatility.

The Proposed Methodology uses similar labels to the IFIC Methodology; however, these labels are aligned with different volatility ranges. Implementing the Proposed Methodology would result in investors perceiving that a fund has experienced an increase in risk when none has occurred. This would therefore be very confusing and would be contrary to Principle 2.

Principle 3: The Methodology should be meaningful and allow for easy comparison across investment funds

The IFIC Methodology allows for easy comparison across funds by developing and maintaining standard processes, terminology, categories, and volatility risk descriptions of funds.

For a number of years, IFIC and its members have been providing guidance to all stakeholders by studying and analyzing fund risk methodology and evolving the guidelines accordingly. The guidelines are a result of careful thought and analysis on the part of a number of highly qualified and experienced experts on IFIC's Fund Risk Classification Task Force who review the IFIC Methodology on a yearly basis to ensure it remains meaningful and relevant. The experts on the Task Force have the added advantage of great depth of knowledge and experience dealing with all issues and perspectives related to funds and their risk classification.

Standard deviation is generally easy to compare and is a meaningful measure of fund volatility. Standard industry practice as recommended by the IFIC Methodology is to compare the standard deviation measure of the fund to the standard deviation measure of the fund's CIFSC category over a series of periods (but no period shorter than 3 years, with backfill if necessary). If they are consistent, the fund should be classified according to the CIFSC category.

We recognize that other types of fund risk, both measurable and non-measurable, may exist and that there are circumstances where a fund's historical volatility may not be available or may not be indicative of its future volatility. For this reason, we believe the risk classification is only meaningful if managers also apply qualitative factors to quantitative measures in order to ensure full, true and

plain disclosure. Therefore, fund managers must have the discretion to classify a fund either higher or lower than the volatility category indicated by a strict application of the IFIC Methodology described above.

Since the Proposed Methodology removes the requirement on fund managers to apply other factors in determining risk classification of a fund, the resulting classifications are not meaningful. They may not represent full, true and plain disclosure of all material facts relating to the mutual funds being offered. As such, implementing the Proposed Methodology would result in a less meaningful approach to fund risk classification.

Principle 4: Fund Risk Classification should not be manipulated to the manager's benefit

We believe that a fund risk methodology should not be manipulated for one's own benefit. Deviating from a strict application of the IFIC Methodology should be done only in the interest of making full, true and plain disclosure of all material facts relating to the mutual funds being offered.

The IFIC Methodology recommends that a fund manager should document the reasons for deviating from the methodology when they do so. This provides documentation to more accurately disclose their risk classification methodology and answer any inquiries from stakeholders. We believe that managers should be consistent with the approach they use each year to classify their funds.

Principle 5: The Methodology should be relatively simple and cost-effective for fund managers to implement

The IFIC Methodology has been in use by the vast majority of investment funds for many years. It is simple to apply and understand, and existing processes currently make it cost-effective.

Implementing the Proposed Methodology would be neither simple nor cost-effective. Funds manufacturers would be required to change risk classifications under the Proposed Methodology despite there being no corresponding change in risk. A recent internal survey of IFIC members shows that all firms would be required to make an upward change in the risk classification for a large portion of their funds, with many firms having over 60% of their funds requiring shifts in risk category (please refer to Appendix B for survey results by firm). In many of these situations, the affected funds may no longer be considered suitable for the investor under current SRO rules. Dealer suitability policies and account supervision procedures will have to be reviewed.

By replacing existing fund risk labels with new and potentially confusing labels, the introduction of the Proposed Methodology would cause a high level of investor confusion and disruption to the industry, which is neither simple nor cost-effective and contrary to Principle 5.

Principle 6: The Methodology should enable easy and effective regulatory supervision

The IFIC Methodology includes standard terminology, categories, and volatility risk descriptions of funds and enables very easy and effective regulatory supervision. A fund's risk classification can be readily compared to the risk classification of its CIFSC category. Rationale for classifying in a different risk category will have been documented by the fund manager.

The Task Force would ensure the IFIC Methodology continues to respect the high-level direction and principles as provided by the CSA. If the CSA believes that the IFIC Methodology does not meet their principles regarding fund risk classification, those concerns would be communicated to the Task Force for appropriate resolution and amendment, as required. We would welcome and encourage CSA Staff to participate in the annual Task Force review of the IFIC Methodology to observe and comment on the rigorous process that is applied in the consideration of ongoing adjustments.

Principle 7: As much as possible, the Methodology should be a stable indicator of risk while fairly reflecting market cycles and broad market fluctuations

The IFIC Methodology is specifically designed to ensure stability in risk indicator by using long-term and stable measures of volatility. This stability is facilitated through the IFIC Methodology's recommendation to compare funds against benchmark indices.

Although the Proposed Methodology includes a mechanism to address stability in the classifications, the implementation of the Proposed Methodology will introduce a very high level of instability. With a majority of funds being re-labelled with an apparent higher risk category, without any associated change in the fund's actual risk, investors and distributors will believe that risk has increased, leading them to reduce equity allocations in their investment portfolios. Such action would lead to wholesale levels of de-risking of accounts, resulting in an extreme level of instability and would ultimately be detrimental to long-term performance of investors. It is clear that this "change when nothing has changed" will be highly confusing to all stakeholders, will be extremely disruptive, and will damage investor's long-term performance.

Implementing the Proposed Methodology would therefore be contrary to Principle 7 and would harm the very industry participants the CSA is attempting to protect.

Conclusion

Thank you for providing us with an opportunity to comment on this important issue. Should you have any questions or desire to discuss these comments, please contact me directly by phone at 416-309-2300 or by email at jdelaurentiis@ific.ca.

Yours truly,

THE INVESTMENT FUNDS INSTITUTE OF CANADA

By: Joanne De Laurentiis
President & CEO

Attachments:

Appendix A: Responses to Issues for Comment

Appendix B: Results of Internal IFIC Member Survey

Appendix C: IFIC Voluntary Guidelines for Fund Managers Regarding Fund Volatility Risk Classification (December 31, 2012)

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

#	QUESTION
	Issues for Comment on the Notice and Request for Comment
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 noted in our covering letter, we believe that the CSA should provide high level principles to the industry with respect to fund risk classification methodology, but that the industry should continue to administer the actual methodology. We have a number of specific concerns with the Proposed Methodology, as noted in our responses below. As a result, we do not recommend that the CSA proceed with mandating the Proposed Methodology. Furthermore, we do not recommend adopting the Proposed Methodology as guidance for fund manager, as it would co-exist with the currently used IFIC Methodology, leading to non-comparability of Fund Facts information. If the CSA resolves that a fund risk classification methodology must be mandated, proper consideration needs to be given to mandating the IFIC Methodology, rather than adopting the alternative Proposed Methodology. As noted in our comment letter, the IFIC methodology meets all of the CSA objectives regarding fund risk classification activities. Furthermore, it is already in place and currently used by the vast majority of the industry, thus largely avoiding time, disruption, and confusion related to transition. If the CSA believe that the IFIC Guideline includes specific shortcomings that make its application unsuitable to the objectives of fund risk classification, IFIC would welcome discussions with the CSA with the aim of addressing those shortcomings. In the scenario of implementation of the Proposed Methodology as mandatory, we anticipate a segmented transition period composed of: (i) a fund manager transition, and (ii) a dealer transition. Fund managers will need to generate new risk ratings, while dealers will need to address significant changes to client accounts. We estimate the fund manager transition period to be between one to two years. This would be followed by a separate dealer transition period of up to three years, assuming that current SRO requirements for determining investment suitability remain the same, and, in light of compliance with other regulatory initiatives such as CRM2 and POS3. Any transition would need to be aligned with Fund Facts renewal dates.
2	**We seek feedback on whether the Proposed Methodology could be used in similar documents to Fund Facts for other types of publicly-offered investment funds, particularly ETFs. For ETFs, what, if any, adjustments would we need to make to the Proposed Methodology? For instance should standard deviation be calculated with returns based on market price or net asset value per unit?**

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

#	QUESTION
	We agree with the CSA's criteria and objectives (listed on page 11855 of Annex A) which would require that any documents where description of risk is required should use the same standards as developed for the mutual fund industry.
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 – namely that it will provide consistency and transparency of disclosure and improved comparability of investment fund products. However, we feel that the CSA has grossly underestimated the costs and potential disruption of implementing the Proposed Methodology. CSA Notice 81-324 states that "...the costs of complying with the Proposed Methodology will be minimal..." An internal survey of IFIC Members shows that all firms would be required to make an upward change in the risk classification for a large portion of their funds, with many firms having over 60% of their funds requiring shifts in risk category (please refer to Appendix B for survey results by firm). The dealer and investor impact of the proposed risk band changes will be significant. Under current MFDA requirements, the shifting of products to a higher risk category will result in many accounts in MFDA dealers that are currently considered suitable, to become unsuitable. Under current MFDA requirements, this will result in investors having to either switch products or increase their stated risk tolerance. It is unfortunate that the 'Anticipated Costs and Benefits' section on page 11852 of CSA Notice 81-324 has not considered the potential significant impacts to dealer firms including: • Potential suitability reviews of clients in order to accommodate product risk changes; • adjustments to IT systems, and • risk of potential complaints and litigation. The vast majority of the industry currently uses the IFIC Methodology and we anticipate a much smoother transition and minimal costs if this is maintained. We would be interested in examining the CSA's analysis of the Canadian fund universe which led the CSA to expect risk category changes to occur infrequently.
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?**

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

#	QUESTION
	We recognize that other types of risk, both measurable and non-measurable, may exist. It is also important to note that a fund's historical volatility may not be indicative of its future volatility. For this reason, we believe fund managers must have the discretion to classify a fund either higher or lower than the volatility category indicated by the IFIC Methodology. This should be done in the interest of making full, true and plain disclosure of all material facts relating to the mutual funds being offered, as qualitative factors should also be applied to any quantitative results in order to ensure full, true and plain disclosure. By removing discretion, the Proposed Methodology removes the responsibility of fund managers to consider other items that could affect the risk of a fund, and thus reduces the responsibility to disclose all risk. We believe that a fund manager should document the reasons for deviating from the methodology when they do so. This provides documentation to more accurately disclose their risk classification methodology and answer any inquiries from stakeholders. Whatever method is used, we believe that managers should be consistent with the methodology that they use each year to classify their funds.
	Issues for Comment on the Proposed Methodology – Risk Indicator
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 most comprehensive, easily understood form of risk is historical volatility risk as measured by the standard deviation of fund performance.
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 agree that the standard deviation is an appropriate risk indicator for assessing volatility of a fund, and that volatility should be the primary indicator of risk.
	Issues for Comment on the Proposed Methodology – Monthly Total Returns

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

#	QUESTION
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 a fund's monthly returns to calculate standard deviation is appropriate.
	Issues for Comment on the Proposed Methodology – 10 Year History
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.**
	We agree with the proposed 10 year period as the basis for risk rating disclosure.
	Issues for Comment on the Proposed Methodology – Fund Series / Class Used
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 agree that the total returns of the oldest fund series/class of the securities of the fund be used as the basis for their volatility risk calculation across all fund series/classes, unless an attribute of a particular fund series/class would result in a materially different level of volatility risk (e.g. currency hedging) in which case, the total returns of that particular fund series/class must be used.
	Issues for Comment on the Proposed Methodology – Use of Reference Index Data
10	**Keeping the criteria outlined in the introduction above in mind, do you agree with the criteria we have proposed for the use of a reference index for funds that do not have sufficient historical performance data? Are there any other factors we should take into account when selecting a reference index? Please supplement your recommendations with data/analysis wherever possible.**

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

#	QUESTION
	We agree that an appropriate reference index can be used to backfill for fund returns when those returns are not available, and that doing so eliminates differences in volatility due to differences in inception dates. Standard industry practice as recommended by the IFIC Methodology is to compare the standard deviation measure of the fund to the standard deviation measure of the fund's CIFSC category for the same period. If they are consistent, the fund should be classified according to the CIFSC category. Only if the measures are different would a shorter time period (but no shorter than 3 years, with backfill if necessary) be used to classify a fund. As there currently exist best practices and effective oversight of benchmark selection, we agree that fund managers should have the discretion to select an appropriate reference index to increase the information set of a fund to 10 years. The use of such imputed data appropriately improves the information available and provides a more fulsome basis on which to measure volatility. We would therefore extend this consideration to also allow using imputed data in situations where a fund's past returns are not representative of the fund's current attributes due to material and intentional changes to the fund. For example, if a fund's unit holders vote to modify the IPS of a fund, the intent is that the fund would behave differently than it has previously, essentially making it a new fund. We also note that the requirements that the index be highly correlated to the fund and contain a high proportion of the same securities would likely not to be appropriate or achievable for many fund managers, in particular those pursuing low beta strategies. We would also like to caution the CSA that determining an appropriate reference index may be difficult for funds which intend to behave differently than any existing reference index. In those situations where there is little or no fund history, and where there is no reference index with a 10 year history that is appropriate for a fund, it is not clear how the CSA would recommend the Proposed Methodology be applied.
	Issues for Comment on the Proposed Methodology – Six Category Scale and Risk Bands
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 are generally in agreement with having six category scales. Indeed, the IFIC Methodology used by the vast majority of fund manufacturers historically had six categories of risk for use in classifying funds for the Standard Prospectus. However, in October 2010, the CSA implementation of Point of Sale disclosure required that funds be classified in one of five categories for Fund Facts. The Task Force

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

#	QUESTION

therefore adapted the IFIC Methodology scale by combining the "Very Low" category (SD band of 0 to 1.0, typically containing money market funds and other very short term fixed income funds) into the "Low" category. We continue to believe that it is important for investors to have the ability to distinguish "Very Low" risk funds like money-market funds from other "Low" risk funds. We also believe that the addition of a "Very High" category as set out in the Proposed Methodology provides useful additional information for investors not currently available in Fund Facts.

Standard Deviation	CSA Fund Facts Investment Risk Scale
0 – 6.0	Low
6.0 – 11.0	Low to Medium
11.0 – 16.0	Medium
16.0 – 20.0	Medium to High
>20.0	High

Figure 1 – Current IFIC Fund Risk Standard Deviation Bands

We note that under the Proposed Methodology, the majority of mutual funds would be labeled as "Medium-to-High", while typically exhibiting only a fraction of the volatility of the highest risk investments. Given the range of investment options and associated risk levels, it is not intuitive that broad based equity funds which typically exhibit risk levels consistent with broad markets be considered "Medium-to-High" volatility.

When investors make decisions on where to invest for the long-term, they can choose from a broad range of investment options. These include not only mutual funds, but also cash, fixed income instruments, individual securities, penny-stock, leveraged ETFs, and a myriad of other options. The least volatile of these options exhibit negligible levels of volatility (under 2% per year), and should be considered "Very Low" risk (i.e. the risk of losing money in a year is very low). The most volatile of these options can have very significant volatility (greater than 50% per year) and could be considered "Very High" risk (i.e. the risk of losing a substantial amount of money in a year is potentially very high). It is within this landscape that the Task Force has consistently examined the labeling of risk categories for mutual funds within the IFIC Methodology.

We consider broad equity market funds displaying volatility in the range of 11%-16% to be "Medium" risk, as they have volatility consistent with a broad index. When compared to other investments, it is neither "high" risk, nor is it "low" risk. Funds displaying volatility levels above 20% and are clearly higher risk than a broad index should be considered "High" risk. Funds displaying volatility levels below 6% and are clearly lower risk than a broad index should be considered "Low" risk. Funds that are between categories then get a combined label.

It is a fact that the Proposed Methodology's risk bands and associated labels will lead to large numbers of funds being re-labeled with an apparent higher risk category, without any associated change in the fund's risk. A recent internal survey of IFIC members shows that all firms would be required to make an upward change in the risk classification for a large portion of their funds, with many firms having over 60% of their funds requiring shifts in risk category. This will lead investors and distributors to believe that risk has increased, with the likely

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

#	QUESTION
	impact of reduced equity allocations in their investment portfolios, in order to adjust the overall risk "back" to the "correct" level. Although such action may on the surface appear to improve outcomes, in effect it would be detrimental to long-term performance of investors. Affected investors will be moving from a portfolio with suitable risk/return profile for their circumstances to a portfolio that may not have the ability to produce an appropriate level of long term returns. It is clear that this "change when nothing has changed" will be highly confusing to all stakeholders, will be extremely disruptive, and can damage investor's long-term performance. There is no indication that the CSA proposed bands and associated nomenclature is an improvement to the IFIC methodology. Applying the proposed methodology **while maintaining the bands and labels from the IFIC methodology** would result in very few funds requiring re-classification during implementation of the methodology. This would largely avoid the confusion and harmful impacts to investors associated with the implementation of the proposed methodology. This approach would also significantly reduce the transition time. The application of the labeling schema below would achieve the CSA objective while minimizing investor confusion and industry impact, and therefore should be considered as an improved alternative to the CSA Proposed risk bands and nomenclature.

Risk Category label (IFIC proposed)	SD Bands (IFIC proposed)
Very Low	0 - 2.0
Low	2.0 - 6.0
Low to Medium	6.0 - 11.0
Medium	11.0 - 16.0
Medium to High	16.0 - 20.0
High	20.0 - 28.0
Very High	> 28.0

	Issues for Comment on the Proposed Methodology – Monitoring and Changing of Risk Categorizations
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.**

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

#	QUESTION
	Given that the approach in calculating the volatility of a fund needs to be highly stable, we believe that monitoring more frequently than semi-annually would not be required. However, we do have concerns regarding categorization of "borderline" funds, i.e. funds that have a volatility level that is very near the end of the range. Under the Proposed Methodology, these funds may oscillate between two categories from period to period, requiring regular reclassification, which would not be consistent with the CSA's objective of stability in categorization. The Proposed Methodology includes a mechanism to deal with this situation by examining a series of observation and taking the average results. This does not fully address the issue, as the average category could also oscillate between two categories requiring regular reclassification. We would therefore recommend discretion in classifying "borderline" funds to ensure improved stability of the fund's category.
	Issues for Comment on the Proposed Methodology – Records of Standard Deviation Calculation
13	**Is a 10 year record retention period too long? If yes, what period would you suggest instead and why?**
	A 10 year record retention period seems arbitrary and unusually long in light of other CSA requirements to retain records for seven years from their date of creation. We believe that a seven year record retention period is sufficient.
	Issues for Comment on the Proposed Methodology – Transition Issues
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 funds shifting risk categories, and would impact the large majority of client accounts. Based on current MFDA requirements, these shifts in fund risk categories would need to be addressed through reviews and client meetings to ensure ongoing suitability. Dealers would also have to review their policies and procedures for determining investment suitability and review internal account supervision systems. We urge the CSA to discuss the Proposed Methodology with the Self-Regulatory Organizations to gain additional insight into the potential ramifications to investment suitability. There is little that fund managers and dealers could do to minimize the significant impact of any transition to the Proposed Methodology. In our view, the proposed risk bands should be revisited in order to ensure a smooth continuation. As noted in our response to Question 11,

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

#	QUESTION
	the alternate risk category label wording we have proposed would have a much lower impact on the number of funds shifting risk category.

APPENDIX B – INTERNAL SURVEY RESULTS

Survey of IFIC Members

IFIC Members were asked to provide details on the percentage of their funds that will shift risk categories under the Proposed CSA Methodology.

The survey results in the table below show that 35% to 90% of IFIC Member funds will shift risk categories under the Proposed Methodology. The breakdown by percentage range of funds shifting is as follows for the 19 companies that completed the survey:

Percentage of funds that will shift risk category under Proposed CSA Methodology	Number of firms
0 – 49%	1
50 – 59%	4
60 – 69%	6
70 – 79%	3
80 – 89%	3
90 – 99%	2

The firms included in the table below represent roughly 75% of Canada's mutual fund industry.

IFIC Member	Percentage of funds that will shift risk categories under Proposed CSA Methodology	Notes
Firm A	62%	
Firm B	52%	
Firm C	67%	
Firm D	83%	
Firm E	57%	Funds that would shift to a higher risk category: 51% Funds that would shift to a lower risk category: 6%
Firm F	71%	
Firm G	90%	
Firm H	90%	
Firm I	80%	
Firm J	62%	
Firm K	64%	Funds that would shift to a higher risk category: 61% Funds that would shift to a lower risk category: 3%
Firm L	66%	Funds that would shift to a higher risk category: 65% Funds that would shift to a lower risk category: 1%
Firm M	63%	Funds that would shift to higher risk category: 60% Funds that would shift to lower risk category: 3%
Firm N	78%	
Firm O	70 – 75%	
Firm P	50%	
Firm Q	35%	
Firm R	80%	
Firm S	50 – 60 %	

IFIC

THE INVESTMENT FUNDS INSTITUTE OF CANADA | L'INSTITUT DES FONDS D'INVESTISSEMENT DU CANADA

VOLUNTARY GUIDELINES FOR FUND MANAGERS REGARDING FUND VOLATILITY RISK CLASSIFICATION

Data Updated to December 31, 2012

IMPORTANT NOTICE TO FUND MANAGERS AND DEALERS:

The following voluntary guidelines may be used by Fund Managers to complement their risk disclosure requirements under National Instrument 81-101F1. Note that this document is only intended for use by Fund Managers to help disclose information to their unitholders regarding the historic volatility of the mutual funds that they manage. It is not intended for use as a substitute for undertaking a proper and complete suitability assessment by advisors, compliance officers or retail investors.

For further information about this document please contact:

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CONTENTS

I. INTRODUCTION

The following voluntary guidelines ("guidelines") may be used by fund managers to complement their risk disclosure requirements under National Instrument 81-101F1 – Mutual Funds Prospectus Disclosure (in the 'Who Should Invest in This Fund?' section of the Simplified Prospectus). NI 81-101F1 requires disclosure of *"risk"* in the Simplified Prospectus.

While the Fund Manager may set out a range of risks in a prospectus, generally one of those risks addresses volatility risk. To provide guidance on how that risk could be classified, the Fund Risk Classification Task Force (the "Task Force") of The Investment Funds Institute of Canada ("IFIC") was established to develop guidelines to assist **fund managers** regarding the classification and comparisons of the volatility risk associated with different types of mutual fund categories. These guidelines are designed to assist with standardizing terminology, categories, and volatility risk descriptions of funds.

Standard deviation bands ("SD Bands") have been defined for each fund classification and respective Canadian Investment Funds Standards Committee ("CIFSC") category to categorize a fund's risk. CIFSC categories have been assigned to each of the five bands based on the rolling average historical standard deviation of the most closely related benchmark index to the CIFSC category. The average of the rolling standard deviation has been used to ensure that the assignment of risk bands and the assignment of CIFSC categories within each risk band are enduring.

These guidelines are not mandatory; however, fund managers that have used these guidelines in the past and intend to continue using them should implement the new classification process shown in this update as soon as it is feasible to do so. **Fund managers are reminded to seek their own legal counsel when determining their obligations of disclosure under NI 81-101F1.**

Message to Dealers and Compliance Officers

These guidelines are not intended to be a substitute for a fund dealer's due diligence and know-your-client best practice procedures. Dealers and salespersons must continue to apply those best practices to assess and ensure the suitability of each investment recommended for each client.

II. INTENDED USE OF GUIDELINE CLASSIFICATIONS

The guidelines presented in this document are only intended to help fund managers apply consistent volatility classification methodology and provide risk disclosure for each fund. Fund companies are required by NI 81-101F1 to set out the *"risk"* classification for each fund in the fund's prospectus.

This document is intended for the use of **fund managers.** The guidelines should not be used by dealers and their staff in substitution of comprehensive suitability reviews or for portfolio construction purposes. These guidelines are simply intended to improve the consistency and clarity of volatility classifications for purposes of complying with disclosure required in fund prospectuses. **It is not the volatility of a single fund, but that of the investor's entire portfolio, that should be the focus of the investor, dealer or advisor.**

The guidelines were intended to:

- Introduce a consistent methodology for volatility risk classification by mutual fund managers;
- Improve comparability of volatility risk classification across fund companies;
- Improve volatility risk disclosure in the fund prospectus; and
- Provide a quantitative framework that may be used for assessing historical fund volatility.

The guidelines provide an explanation of the methodology, the categories of classification, and the associated volatility classification for each fund category. The guidelines also set out how this classification system may be applied by fund managers in assessing the volatility risk associated with their funds and address the classification categories for alternative funds (non-81-101 prospectused funds) or non-standard investment strategies.

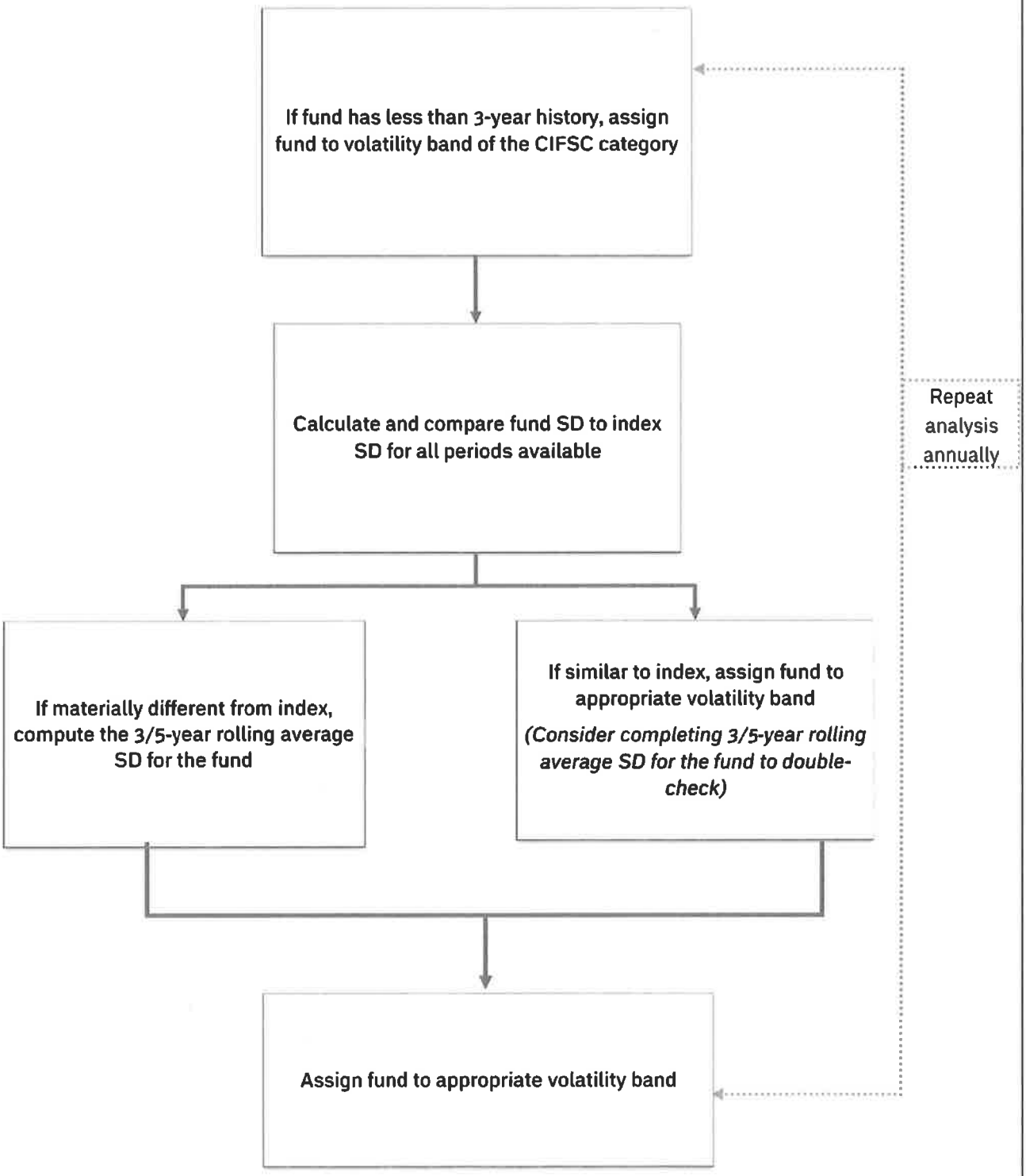
III. APPLICATION OF THE GUIDELINES

Methodology

The following steps detail how to implement the guidelines:

1. If the fund in question does not have at least three years of monthly return history, the benchmark index that most closely resembles the investment mandate or strategy of the fund may be used as a proxy.
2. Determine the fund's average annual standard deviation for each cumulative period going back 10 years (if available). Compare these results to the appropriate index in **Appendix 2**. If the fund's standard deviation for each period does not differ materially from the appropriate index, categorize the fund using the risk band that contains the appropriate CIFSC category.
3. If the fund's standard deviation for each period differs materially from the appropriate index, determine the average of the rolling three- and/or five-year standard deviations for the fund. Use of the average of rolling five-year standard deviations should result in a more stable volatility risk classification over time. Even if the fund's standard deviation for each period does not differ materially from the appropriate index, we suggest that fund managers complete this step.
4. Compare the fund's average three-year standard deviation to the SD Bands as presented in **Appendix 1** in order to determine the appropriate volatility classification.
5. Consider placing the fund in a higher or lower volatility classification, as appropriate, if:
    a) the fund's average standard deviation is not within the SD Band indicated for that fund's particular CIFSC category; or
    b) the fund's standard deviation differs materially from a benchmark index proxy due to particular manager style, process, or other qualitative factors.
6. Repeat this analysis each year prior to prospectus renewal to ensure that fund volatility risk classifications remain up-to-date and appropriate. This analysis should be repeated earlier if there has been a material change to the fund's investment strategy and/or investment objective.
7. Managers should be consistent with the methodology that they use each year to classify their funds.
8. Where fund managers deviate from the above-described approaches, the reasons for deviating should be documented in order to accurately disclose their risk classification methodology and answer any inquiries from stakeholders.

Flowchart for applying guidelines



Fund managers have the discretion to classify a fund either higher or lower than the volatility category indicated by the guidelines. This should be done in the interest of making full, true and plain disclosure of all material facts relating to the mutual funds being offered, as qualitative factors should also be applied to any quantitative results in order to ensure full, true and plain disclosure.

> *Example: Fund Manager understands that an aggressively-managed Canadian equity fund is likely to be more volatile, or more risky than the average Canadian equity fund or the Canadian equity benchmark. For full, plain and true disclosure, it may be appropriate to classify that fund at a higher volatility category than that suggested by these guidelines. A manager should examine the style, security selection process, or other qualitative factors of their fund in addition to the standard deviation in order to make this determination.*

Similarly, because certain funds are difficult to compare to a standard benchmark (i.e. hybrid funds), it is recognized that some flexibility in the assignment of volatility category must be given to fund managers.

Fund managers are not required to incorporate these guidelines as a component of their internal fund risk assessment processes. Fund managers who fully adopt these guidelines into their risk classification methodologies must use the Statement of Use shown below when referring to these guidelines in addition to other required disclosures. Fund managers who adopt these guidelines only in part should modify this Statement of Use as appropriate. It is each fund manager's responsibility to ensure full, true and plain disclosure in compliance with all applicable regulatory requirements.

Statement of Use

"The methodology used to determine the volatility risk ratings of the funds for purposes of disclosure in this prospectus is the methodology recommended by the Fund Risk Classification Task Force of the Investment Funds Institute of Canada. The Task Force concluded that the most comprehensive, easily understood form of risk in this context is historical volatility risk as measured by the standard deviation of fund performance. However the Task Force recognizes that other types of risk, both measurable and non-measurable, may exist. It is also important to note that a fund's historical volatility may not be indicative of its future volatility."

Adapting volatility risk classifications for use in Fund Facts

In October 2010, the Canadian Securities Administrators (CSA) began the implementation of Point of Sale disclosure for mutual funds (Stage 1). Fund managers were required to identify the fund's investment risk level on the Fund Facts document using a five category scale with the following category nomenclature - Low, Low to Medium, Medium, Medium to High, and High.

The IFIC Fund Risk SD bands have a direct translation to an investment risk category in the Fund Facts document as follows:

Standard Deviation	CSA Fund Facts Investment Risk Scale
0 – 6.0	Low
6.0 – 11.0	Low to Medium
11.0 – 16.0	Medium
16.0 – 20.0	Medium to High
>20.0	High

Maintenance of the guidelines

- This document will be reviewed annually and updated as appropriate.
- IFIC's Ad-Hoc Strategic Research Committee will direct the Fund Risk Classification Task Force to ensure that the fund categories, volatility classifications and standard deviation bands continue to accurately reflect the industry.
- The Task Force will assess the continued applicability and reasonableness of the SD Bands as defined.
- The Task Force will assess the continued applicability and reasonableness of the three- and five-year time periods.

IV. HOW THESE GUIDELINES WERE DEVELOPED

a) Objectives

The Task Force established a subcommittee to review various options for categorizing overall fund volatility risk for the purposes of meeting the Simplified Prospectus and Fund Facts disclosure requirements. The subcommittee's goal was to recommend a method for measuring and categorizing volatility for various asset categories.

There were two essential requirements for this categorization:

- Sufficient categories are needed to adequately differentiate between different fund types, but the number of categories must also be limited in order to facilitate understanding, acceptance and comparability across funds; and
- The solution should help fund managers disclose information about this risk in an unambiguous and understandable way to investors.

The subcommittee considered a wide range of ways to measure risk or volatility of a fund: standard deviation, downside deviation (semi-variance), value at risk, risk attributes (for example, political risk, currency risk, derivative risk, among others), and risk/return measures such as Sharpe and Sortino ratios.

Standard deviation met the subcommittee's criteria as an unambiguous and relatively well-established and well-understood measure of volatility risk. Some industry observers have argued that upside volatility is also important and should be included in a total risk analysis. Standard deviation has broad support in the industry as a method for measuring total return volatility.[1] Both upside and downside risk are captured by standard deviation. Standard deviation provided a quantitative framework for assessing fund volatility; which also allowed qualitative factors to be considered to ensure full disclosure.

b) Analysis

The subcommittee then prepared a volatility analysis using the following methodology:

1. A broad range of market indices and comparative benchmarks was selected to represent the different asset categories available to investors. The lists of indices and benchmarks are provided in **Appendices 2** and **3**. For consistency, all non-Canadian indices are denominated in Canadian dollars;
2. The subcommittee calculated standard deviation for these indices and benchmarks over rolling one-, three-, five-, ten-, twenty- and thirty–year periods (where data permitted). The averages of the rolling time periods were then calculated. The data results and graphs are captured in **Appendices 2 and 3.** Using rolling time frames avoided end-date sensitivity in the data. The

[1] See for example, Clare, Andrew, "Developing a Risk Rating Methodology," *Joint Association of British Insurers (ABI) and Investment Management Association (IMA) Research Paper, 2010*, and "CESR's guidelines on the methodology for the calculation of the synthetic risk and reward indicator in the Key Investor Information Document," *Committee of European Securities Regulators*, July 1, 2010.

subcommittee calculated the average annual standard deviation for all indices over 1-year through 10-year periods for funds that have been in existence for less than 10 years;

3. The subcommittee focused on three- and five-year time periods, as these were considered to represent a typical investor time horizon. The subcommittee ensured that any conclusions drawn from these time periods were supported by longer-term data; and

4. The risk analysis was compiled using data supplied directly by index providers.

5. There appeared to be some natural breakpoints in the data around major asset classes:
    - Cash equivalent and Short-Term Fixed Income,
    - Fixed Income,
    - Balanced,
    - Equity - this was the broadest group, consisting of sectoral and geographic categories.

c) Selection process

The subcommittee was left with three options from which to select:

1. categorize fund volatility according to the standard deviation of the benchmark which best represents the fund's expected performance;
2. define absolute standard deviation breakpoints (for example, annualized standard deviation of less than 5% over rolling three-year periods would be defined as low risk); or
3. utilize standard deviation as a first sort of risk. Apply a further overlay of the fund's downside risk, or exposure to various other sources of risk (for example, currency, political, concentration, etc).

The subcommittee recommended the option to *categorize broad asset class volatility based on historical standard deviations of applicable benchmarks.*

d) Use of benchmark indices

Common or standard benchmarks were recommended as proxies to evaluate the volatility risk for different types of mutual funds in order to establish standard deviation risk bands for various CIFSC categories. The use of benchmarks provided a long time series for analysis, and provided a solution for assessing the volatility risk associated with new funds.

e) Risk measure

While any single risk measure had limitations, standard deviation was recommended as an acceptable quantitative measure of volatility risk.

Standard deviation met the criteria of being unambiguous and relatively well-established and well-understood as a measure of volatility risk. Both upside and downside volatility risk were captured by standard deviation.

Standard deviation: a measure of the dispersion of a set of data from its mean - the more widely dispersed the data points, the higher the implied volatility, and thus, the higher the deviation. Standard deviation is a common statistic used to measure the volatility (risk) of an investment.

Any risk factor, whether it be currency risk, derivative risk, etc., will somehow affect the unit price and therefore, the fund's performance, making it a measurable risk. If the risk is 'priced into' the daily unit price, it will also be 'priced into' the fund's performance and, therefore, included in the standard deviation of the fund's performance. It must always be remembered that standard deviation is a backward-looking measure. As historical performance may not be indicative of future returns, a fund's historical volatility may not be indicative of its future volatility.

f) Time period of the risk measure

Both a rolling historical average of three- and five-year measures of standard deviation were used to analyze the volatility of benchmark indices in order to determine SD Bands.

The use of the two time periods not only provided a check to ensure one measure was not an anomaly, but added to the robustness of the analysis. Using the average of rolling periods addressed concerns regarding end-point sensitivity and was based on the experience of fund companies that investors typically hold mutual funds for three to five years.

g) Volatility risk categories

As Fund managers use the same nomenclature for the categories of volatility risk, this would allow for greater clarity and better disclosure to investors. Fund classifications were developed according to the SD bands listed in **Appendix 1**, and the following five categories of volatility risk:

1. Low
2. Low to Medium
3. Medium
4. Medium to High
5. High

Appendix I: Volatility Classification, Asset Categories and Risk Scale

Asset Categories[†]	SD Band	Volatility Classification
Canadian Money Market (must have fixed unit price) U.S. Money Market (must have fixed unit price) Canadian Synthetic Money Market (must have fixed unit price) Canadian Fixed Income Canadian Short-Term Fixed Income	0-6.0	Low
2015 Target Date Portfolio[1] 2020 Target Date Portfolio[1] 2025 Target Date Portfolio[1] 2025+ Target Date Portfolio[1] Canadian Equity Balanced Canadian Fixed Income Balanced Canadian Inflation Protected Fixed Income Canadian Long Term Fixed Income Canadian Neutral Balanced Global Equity Balanced Global Fixed Income Global Fixed Income Balanced Global Neutral Balanced High Yield Fixed Income Tactical Balanced[1]	6.0-11.0	Low to Medium

[†] Asset categories come from the Canadian Investment Funds Standards Committee as of December 31, 2012 (www.cifsc.org).

Asset Categories[1]	SD Band	Volatility Classification
Canadian Dividend & Income Equity Canadian Equity Canadian Focused Equity European Equity Global Equity International Equity North American Equity U.S. Equity	**11.0-16.0**	**Medium**
Asia/Pacific Equity[2] Canadian Focused Small/Mid Cap Equity[2] Canadian Small/Mid Cap Equity Financial Services Equity[2] Global Small/Mid Cap Equity[2] Health Care Equity[2] Real Estate Equity U.S. Small/Mid Cap Equity	**16.0-20.0**	**Medium to High**
Asia Pacific ex-Japan Equity Emerging Markets Equity Japanese Equity Greater China Equity Labour-Sponsored Venture Capital[3] Precious Metals Equity Natural Resources Equity[4]	**>20.0**	**High**
Alternative Strategies[5] Miscellaneous – Income & Real Property[6] Miscellaneous – Leveraged[6] Miscellaneous – Commodity[6] Miscellaneous – Geographic Equity[6] Miscellaneous – Sector Equity[6] Miscellaneous – Other[6] Miscellaneous – Undisclosed Holdings[6]	**N/A**	**N/A**

Managers may classify a fund with a higher or lower volatility classification than appears in the guidelines as qualitative factors should also be applied to any quantitative results in order to ensure full disclosure.

It is recognized that managers must be given the latitude to classify a fund either higher or lower than the volatility category indicated by the guidelines, in the interest of making full, true and plain disclosure of all material facts relating to the mutual funds being offered.

Notes to volatility classifications

1 Target-Date Portfolios and Tactical Balanced funds should be compared to the most relevant benchmark depending on the asset allocation of the particular fund. Fund managers should also consider utilizing a custom benchmark for these funds.

2 Although the data for these categories suggests that they should be placed in the Medium volatility risk band, the Task Force recommended that, due to the narrow focus – either in terms of market cap or sector - of the funds in these categories, placement in the Medium to High volatility risk band would be more appropriate.

3 Labour-Sponsored Venture Capital — while a suitable benchmark for this category does not exist, these funds are typically regarded as high volatility vehicles due to the nature of the investments and the inherent risk in venture capital investments.

4 Although the data for the Natural Resources Equity category suggests that it should be placed in the Medium to High volatility risk band, the Task Force recommended that, due to the narrow focus – either in terms of market cap or sector - of the funds in this category, placement in the High volatility risk band would be more appropriate.

5 Alternative Strategies — due to the wide variation in fund types within this category, these funds, by default, should be classified as High volatility. If a fund company wishes to classify an alternative strategies fund in a lower volatility category, an explanation should accompany the disclosure.

6 Miscellaneous Sub-Categories — due to the wide variation in fund types within these categories, these funds should not be classified according to this guideline. Fund companies must accompany the volatility category selected for such a fund with an explanation.