Eric Adelson
Senior Vice President and Head of Legal
T: 416.228.3670
F: 416.590.1621
Email: eric.adelson@invesco.com

Invesco
5140 Yonge Street, Suite 800
Toronto, Ontario M2N 6X7
Telephone: 416.590.9855 or 1.800.874.6275
Facsimile: 416.590.9868 or 1.800.631.7008
www.invesco.ca

March 9, 2016

VIA E-MAIL

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)
Office of the Superintendent of Securities, Prince Edward Island
Nova Scotia Securities Commission
Office of the Superintendent of Securities, Newfoundland and Labrador
Office of the Superintendent of Securities, Northwest Territories
Office of the Yukon Superintendent of Securities
Office of the Superintendent of Securities, Nunavut

Attention:
The Secretary
Ontario Securities Commission
20 Queen Street West
22nd Floor
Toronto, Ontario M5H 3S8
comments@osc.gov.on.ca

Me Anne-Marie Beaudoin
Corporate Secretary
Autorité des marchés financiers
800, rue du Square-Victoria, 22e étage
C.P. 246, tour de la Bourse
Montréal (Québec) H4Z 1G3
consultation-en-cours@lautorite.qc.ca

Dear Sirs/Mesdames:

Re: CSA Mutual Fund Risk Classification Methodology for Use in Fund Facts – Proposed Amendments to NI 81-102 *Investment Funds* and Related Consequential Amendments (the "Proposed Amendments")

We are writing in respect of the request for comments dated December 10, 2015 regarding the Proposed Amendments. We appreciate the opportunity to comment on these important matters.

Invesco Canada Ltd. is a wholly-owned subsidiary of Invesco Ltd. Invesco is a leading independent global investment management company, dedicated to helping people worldwide build their financial security. As of February 29, 2016, Invesco and its operating

subsidiaries had assets under management of approximately US$741 billion. Invesco operates in more than 20 countries in North America, Europe and Asia.

Invesco Canada is registered as an Investment Fund Manager, an Adviser and a Dealer in Ontario and certain other provinces. Our investment products are primarily bought by and sold to retail investors. As such, we take a great interest in regulatory discussions that impact those investors.

We have previously commented on CSA Notice 81-324 and Request For Comment *Proposed CSA Mutual Fund Risk Classification Methodology for Use in Fund Facts* wherein we submitted that standard deviation is not an appropriate measure of risk for a retail investor because retail investors are less concerned with periodic fluctuations in the value of their investments than they are with the risk of loss of capital. (We also noted the inherent dangers of oversimplifying a complex concept into misleading nomenclature.) In that submission, we concluded that best/worst period performance and recovery times are better measures of risk for a retail investor since that gives an indication of not only the maximum impairment of capital that a particular mutual fund has had historically but also an indication of how long it might take to recover from such an impairment of capital. Importantly, virtually every investor who submitted comments, virtually every "investor advocate" (including the Ontario Securities Commission Investor Advisory Panel, the Small Investor Protection Association of Canada, Kenmar Associates and, to a significantly lesser degree, the Foundation for the Advancement of Investor Rights), and even some of our industry colleagues expressed views similar to both our submissions and the conclusions that we drew. As such, we are surprised that the Canadian Securities Administrators (the "CSA") wholesale rejected these submissions in a rule proposal designed to protect retail investors. We urge the CSA to reconsider this approach.

Assuming that the CSA will not reconsider its approach, we will limit our comments to one specific concern we have with the Proposed Amendments, namely the criteria for using a reference index where a mutual fund has less than 10 years of performance history (being the vast majority of mutual funds offered in Canada) which are included in the instruction to Item 4 (the "Instruction") of proposed Appendix F to National Instrument 81-102 *Investment Funds* ("NI 81-102"). It is not clear whether a proposed reference index must meet all 10 criteria listed in the Instruction or if an investment fund manager needs merely to consider those criteria in selecting a reference index. (In the latter case, the CSA implicitly acknowledges that in some cases, many criteria cannot be met, although if that is the case, we believe an explicit statement to that effect would not only be helpful but necessary.) In some cases, it is not at all clear what some of the criteria even mean and, therefore, we would urge the CSA to clarify this in a future publication. Our letter is organized as follows: first, we will discuss the specific reference fund criteria that raise the greatest concerns for a true active manager such as ourselves; next, we will highlight those criteria which we believe require further explanation from the CSA; and finally, we will propose an alternative to the 10 criteria to be used in selecting a reference index.

Reference Fund Criteria That Raise the Greatest Concerns

Please note that for the purpose of drafting our comments contained in this letter, we assumed that none of the mutual funds that we manage have a 10 year track record and, therefore, we considered what would be an appropriate reference index for each of our mutual funds. In some cases, we adopted a blended index and in other cases we adopted a single index. In each case, the use of the reference index selected is consistent with the primary benchmark that we use in the performance discussion contained in the Management Report of Fund Performance ("MRFP") for each of the mutual funds that we

manage.[1] All of the data presented below is based on a comparison of a specific mutual fund with the benchmark that forms the basis for discussion in the MRFP of the mutual fund.

Criterion (c): The reference index "contains a high proportion of the securities represented in the mutual fund's portfolio with similar portfolio allocations." This criterion requires there to be not only a high degree of overlap between the portfolio securities of the mutual fund and the constituent securities of the proposed reference index, but also a high degree of overlap in the weightings of individual securities in the mutual fund's portfolio compared with the constituent securities of the proposed reference index. This relationship is best examined by the "active share"[2]; in other words, only if the mutual fund has a low active share relative to the particular proposed reference index will that reference index satisfy this criterion.

Using the primary benchmarks in our MRFPs, as at December 31, 2015, not one Trimark-labelled mutual fund had an active share below 70%. To put this in context, the financial literature generally accepts an active share of 60% as the cut-off between a true active manager and a closet indexer[3]. Of our Trimark-branded funds, 7 had an active share greater than 70%, 8 had an active share greater than 80% and 13 had an active share greater than 90%[4]. More striking, of our Trimark-branded global equity funds, the lowest active share was 89%. Similarly, for our Invesco-branded funds, only 1 had a low active share (50%). Of the remainder, 5 had an active share about 75% and 5 (all of which are global equity funds) had an active share above 80%. We did not repeat this exercise with our PowerShares-branded funds since these are primarily passive, index-based products.

To our knowledge, it is not possible to find reference indices for these mutual funds that would result in the mutual fund having an active share below 60%. We suspect that we are not alone amongst active managers in facing this issue. Accordingly, we strongly urge the CSA to remove this criterion from the Instruction.

We note with interest that the Ontario Securities Commission (the "OSC") recently announced that it is concerned that some investment funds are being promoted as true actively managed funds when, in reality, they are closet index funds.[5] Recently, securities regulators in other parts of the world have also raised this concern. We take note of this because the effect of this criterion, if we have interpreted it correctly, is to dissuade investment fund managers from establishing new actively-managed mutual funds. We submit that is bad public policy and should not be adopted, encouraged or accepted.

Criterion (d): The reference index "has a historical systemic risk profile similar to the mutual fund." Systemic risk is measured by *beta*[6]. This criterion requires the *beta* of the mutual fund to be similar to the *beta* of the proposed reference index. It is simple to conclude that a mutual fund with a *beta* equal to 1 in relation to a particular benchmark, has the same systemic risk as that benchmark. However, such an outcome is at best a remote possibility and the CSA appears to recognize this by using the word "similar".

[1] Note that we typically disclose a broad-based index in the MRFP and either a blend of indices or a more specific but not broad-based index that we believe is more consistent with the mutual fund's objectives and strategies. It is one of these that is typically the primary benchmark upon which we base our discussion.
[2] Investopedia.com defines "active share" as a "measure of the percentage of stock holdings in a manager's portfolio that differ from the benchmark index."
[3] Petajisto, Antti, "Active Share and Mutual Fund Performance", *Financial Analysts Journal*, Vol. 69, No. 4.
[4] This sample constitutes all Trimark funds available to retail investors but only counts each fund once, notwithstanding differences in series available.
[5] *The Globe and Mail*, Friday, March 4, 2016.
[6] http://www.investopedia.com/terms/r/riskmeasures.asp

In our view, systemic risk within 10% of the proposed reference index would meet the criterion of "similar", although we would appreciate if the CSA could clarify this in their response to comments on the Proposed Amendments. On this basis, therefore, we have examined our Trimark and Invesco funds to determine how many would fit within the 0.90 to 1.1 range for *beta*, based on December 31, 2015 data.

First, we examined the *beta* of each of our mutual funds over the 3 year period ending December 31, 2015. In the case of the Trimark-branded funds, only 11 of 28 have a *beta* between 0.9 and 1.1. Therefore, 17 of the 28 Trimark funds could not use the benchmark (blended or otherwise) that they use in the MRFP and in our marketing materials as a reference index under the Proposed Amendments. For the sake of completeness, in the case of the Invesco-branded funds, we found that 9 of 11 funds have a *beta* within the range of 0.9 to 1.1. If the range were increased to 20%, then an additional 7 Trimark funds and 1 Invesco fund would be able to meet this criterion. However, a 20% difference is typically considered "material" both from the perspective of an investor and for purposes of securities legislation. Therefore, it is not clear how 20% could be consistent with the word "similar."

Next, we expanded the analysis to examine the *beta* of each of our mutual funds over the 5 year period (where such exists) ending December 31, 2015. 12 of 25 Trimark funds fell within the 10% range noted above. Of the 13 that fell outside the 10% range, 7 would have fallen within a range set at 20%. For the Invesco funds, 7 of 11 funds fell within the 10% range and all of the funds fell within the 20% range. As such, properly defining "similar" is quite important.

This criterion will prove problematic for some actively-managed funds but not for all and not to the same degree as criterion (c). However, the fact that close to half of our mutual funds overall would not be able to find a reference index that satisfied this criterion suggests to us that this is not a unique issue for our firm. As such, we believe the CSA should re-consider the inclusion of this criterion. Alternatively, the CSA should better define the meaning of "similar". Furthermore, as the measurement period affects the calculation of *beta*, the CSA should provide some guidance as to the appropriate period to measure *beta* for purposes of meeting this criterion.

Criterion (e): The reference index "reflects the market sectors in which the mutual fund is investing." There are at least three ways to interpret the quoted phrase, all of which yield different results. We will set out our three interpretations below with comments relevant to each and ask the CSA to clarify which interpretation is correct.

The first interpretation is that the market sectors in the mutual fund should be included in the reference index but there may be some sectors in the reference index not included in the mutual fund. Furthermore, under this interpretation the sector weightings of the mutual fund relative to the proposed reference index are not relevant. The key point would be that as long as most of the sectors represented in the proposed reference index are found in the mutual fund the proposed reference index would satisfy this criterion. As a result of our investment style, Trimark funds often do not invest in every sector represented by the index nor do our funds invest in anywhere near the weightings that stocks represent in given indices. Therefore, this would be our preferred interpretation. Furthermore, we would prefer an interpretation whereby not less than half of the sectors represented by the proposed reference index are represented in the mutual fund.

The second interpretation of criterion (e) is that the sectors in which the mutual fund invests must all be represented in the proposed reference index and all sectors in the proposed reference index must be invested in by the mutual fund. As in the first

interpretation above, the weightings of individual stocks in the reference index would not be relevant. We dislike this interpretation as discussed below.

Under this interpretation, if a mutual fund is exposed to a sector not contained in the proposed reference index or the proposed reference index contains a sector in which the mutual fund is not invested, the proposed reference index would not satisfy this criterion. For the Trimark investment style, this is problematic. For example, Trimark Europlus Fund uses as its benchmark the MSCI Europe Index (C$), a benchmark widely used by investment fund managers for European equity funds. This index, as at September 30, 2015 had a 6.5% weighting in energy, a 5% weighting in telecommunication services and a 4% weighting in utilities. Like all equity indices, it had a 0% weighting to cash. The Fund, in contrast, had a 0% weighting in each of those sectors and an 18% weighting in cash. Therefore, the Fund was not invested in 3 of the 10 sectors represented by the index. This conclusion would apply to 27 of the 28 Trimark-branded funds discussed elsewhere in this letter, with anywhere between 1 and 4 sectors represented in the index used missing from the corresponding mutual fund. We have found that similar concerns arise with many of our Invesco funds.

This interpretation (as well as the third interpretation, below) is inappropriate for a truly actively-managed portfolio as the investment fund manager (in structuring the mutual fund) or the portfolio manager (in managing the investment portfolio of the mutual fund) could find itself in the position of having to alter the investment portfolio of the mutual fund in order to find a reference index that satisfies the criteria contained in the Instruction. Perversely, this could result in one portfolio management approach for the first 10 years of a mutual fund and a different approach, i.e. that which was originally intended, subsequently. Even worse, this could in effect result in a regulation that serves to dictate what investments are made by a mutual fund[7]. We are quite certain that the CSA do not intend this effect but without clarification, this is certainly a possible result.

The third interpretation is the same as the second with the additional requirement that sector allocations are similar. We would be troubled by this interpretation for similar reasons to the previous interpretation. For example, Trimark global equity funds are typically underweight energy and materials and overweight consumer-oriented sectors, often by double-digit percentage points. If this interpretation prevails, we would have no choice but to commission new indices for those mutual funds and, as discussed below, it is not clear that an acceptable reference index can even be created.

Criterion (f): The reference index "has security allocations that represent invested position sizes on a similar pro rata basis to the mutual fund's total assets". We interpret this as meaning that the average weighting of a constituent security in a proposed reference index should be roughly the same size as the average weighting of securities in a mutual fund's portfolio. For example, if the index typically has an average weighting of 0.5% for each constituent but the mutual fund runs a concentrated portfolio with a 4% weighting for each portfolio security, the proposed reference index would not satisfy this criterion. This presents a problem for the Trimark funds because one of the primary differentiators of the Trimark investment style is to run concentrated portfolios, which could have as few as 25 portfolio holdings and as many as 50 (in most cases). This approach implies an average weighting of 2% to 4% for portfolio securities held in Trimark

[7] We make this point because, in creating new mutual funds following implementation of the Proposed Amendments, the investment fund manager cannot even file a simplified prospectus and fund facts document without a risk classification, which depends on finding an appropriate reference index. Therefore, if an appropriate reference index does not exist for a new mutual fund, the mutual fund could never file compliant disclosure documents.

funds. In contrast, the S&P 500 Index, as the name implies, has an average weighting of 0.2%. The MSCI Europe Index, with 446 stocks has an average weighting of 0.2% and the S&P/TSX Composite Index, with 239 stocks has an average weighting of 0.4%. We would expect most new global equity funds to consider using the MSCI World Index as its reference index. However, that index has 1650 constituent securities and, as such, one would not expect that such index could satisfy this criterion. Based on the foregoing, it seems evident to us that it would be extraordinarily difficult, if not impossible, for a mutual fund with a concentrated portfolio to find a reference index that meets this criterion.

Criteria That Require Further Clarification

Criterion (a): The reference index "is made up of one or a composite of several market indices that best reflect the returns and volatility of the mutual fund and the portfolio of the mutual fund." In our opinion, this is a very vague statement. We seek CSA guidance on the meaning of "best reflect the returns and volatility" of the mutual fund and we do not understand the distinction drawn in the criterion between "the mutual fund" and "the portfolio of the mutual fund."

Criterion (b): The reference index "has returns highly correlated to the returns of the mutual fund." The phrase "highly correlated" is ill-defined in Canadian securities legislation and, as a result, leads to high degree of different interpretations and, hence, different applications. The best example of this is the use of the phrase in the definition of "hedging" in NI 81-102. Some portfolio managers believe the high negative correlation requirement in that definition is satisfied at a negative 60% correlation, while others use 70% or 75%. (We are not aware of any who use a higher number than that although our sampling on this is not statistically significant.)

Criteria (h) and (j): The reference index "has its returns computed on the same basis (e.g. total return, net of withholding taxes, etc.) as the mutual fund's returns" and "is based on an index or indices that have each been adjusted by its index provider to include the reinvestment of all income and capital gains distributors in additional securities of the mutual fund." We read each of these criteria as requiring the reference index to be computed on a total return basis with perhaps the sole difference being that if the mutual fund makes other deductions in computing NAV (such as taxes) then the proposed reference index has to as well. If that is the case, it is not clear to us why two criteria are used instead of just one, i.e. use a reference index that is computed in the same manner as a mutual fund is required to calculate performance, as set forth in section 15.10 of NI 81-102.

Potential Solutions

It is simply not possible for a reference index to have return and portfolio characteristics similar to those of an actively managed mutual fund that is not, in reality, a closet index fund.

In previous discussions with Staff at the OSC, we have been advised that there is nothing in the rule that prevents a manager from commissioning an index in order to meet these criteria. Oddly, at the time that comment was made to us, the proposal on the table required a reference index to be widely quoted and available. We criticized that in our previous comments and we are pleased that the CSA accepted such comments. However, it appears to us that the CSA has not closed the door to this solution due to Criterion (i) of the Instruction which requires that any index used for these purposes be created and administered by an unaffiliated third party. As an investment fund manager that also offers exchange-traded funds, we are familiar with index creation and maintenance. Significant

fees may be involved and it might even be impossible to create the desired index. At this stage, based on our discussions with index providers, they simply have not turned their minds to this issue as we are unable to even get price quotes from the providers to determine what our costs might be to create compliant reference indices. What we do know is that the simplest of indices would cost a minimum of $5,000 to $15,000 to create (that does not include annual maintenance) and that the price increases with each additional element of complexity. As shown above, we would need many elements of complexity for a compliant reference index to be used in creating risk classification ratings for Trimark funds with a track record less than 10 years. If this expenditure created something of value for mutual fund investors, it would be difficult to argue that the expenditure is not worth the money, but that is not the case. Risk classification itself is an inherently inexact endeavour. The Proposed Amendments already take a complex subject-matter and try to break it down to something that a financially illiterate individual could understand. Even though the standard deviations of mutual funds might range from 0% to as high as 30%, this gets distilled into 5 categories. To make matters worse, instead of giving an indication as to what the standard deviation is for a particular mutual fund, this gets translated into a label: low, low to medium, medium, etc. In light of that, it is startling that the CSA would continue to push for such exactitude on a reference index. We note that the IFIC Risk Classification Guidelines, upon which the Proposed Amendments are obviously based, does not have such a requirement and for good reason: it is expensive and cumbersome to administer and does not provide any better information for an investor.

As things stand today, every mutual fund is required to select one of more benchmarks upon which to compare their performance in the MRFP. The criteria relating to the use of the index are simple to apply. Fund managers are permitted to create their own blends to create a benchmark that provides a better comparison, as long as a broad-based market index is also used. It is really these blended indices that would provide the best proxy as a reference index for purposes of the Proposed Amendments: not because they provide more exactness but because they are easy to use and simple to administer and the "leakage" of precision compared to the 10 criteria for a reference index do not make a significant difference to the outcome.

As such, we propose the following:

- Subject to providing proper explanation of criteria (a) and (b) as discussed above, maintain those criteria;
- Maintain criteria (g) and (i);
- Replace criteria (h) and (j) with a requirement that the performance of the reference index be calculated in the same manner as a mutual fund is required to calculate performance under section 15.10 of NI 81-102;
- Explicitly state that the reference index for use in this context can be the index used for the benchmark in the MRFP and that if a benchmark is used in addition to the broad-based benchmark, the additional benchmark should be used as the reference index;
- Explicitly state that an investment fund manager that uses the MRFP benchmark will be deemed to be in full compliance with applicable regulation and that such use offers the investment fund manager a full defense to any claims of misrepresentation relating to the use of reference index data;

- Provide for at least a 1 year transition period to allow truly active managers sufficient time to consider an alternative and apply to their principal regulator for relief from this requirement.

If the list of criteria contained in the Instruction is maintained then it is incumbent upon the CSA to provide further guidance, in the form of a Companion Policy, stating what it means by the opening words of the Instruction, namely that a "mutual fund should consider". The plain meaning of that phrase is that the mutual fund should consider the criteria but may freely choose not to apply the criteria after such thought has been given and without fear of regulatory repercussion. If that is the case, then it would be helpful to all to so state and this (and I suspect other similar) comment letters serve no purpose other than to remind the CSA of the need for clarity and precision in drafting rule proposals. One might also interpret the phrase as meaning that the CSA expects most, but not all, of the criteria to be met for a reference index selection. Even if that is the case, such clarity would be helpful. It is not clear to us why the CSA would not provide that.

Thank you for providing us with the opportunity to comment on this important initiative. We would be pleased to discuss our comments further should you so desire.

Yours very truly,

Invesco Canada Ltd.

Eric Adelson
Senior Vice President and Head of Legal – Canada