CSA MUTUAL FUND RISK CLASSIFICATION METHODOLOGY FOR USE IN FUND FACTS AND ETF FACTS

CSA NOTICE OF AMENDMENTS TO NATIONAL INSTRUMENT 81-102 INVESTMENT FUNDS AND RELATED CONSEQUENTIAL AMENDMENTS

December 8, 2016

Introduction

The Canadian Securities Administrators (the **CSA** or **we**) are making amendments to mandate a CSA risk classification methodology (the **Methodology**) for use by fund managers to determine the investment risk level of conventional mutual funds and exchange-traded mutual funds (**ETFs**) (which are collectively referred to as **mutual funds**) for use in the Fund Facts document (**Fund Facts**) and in the ETF Facts document[1] (**ETF Facts**) respectively.

The amendments are to:

- National Instrument 81-102 *Investment Funds* (**NI 81-102**).

We are also making related consequential amendments to:

- National Instrument 81-101*Mutual fund Prospectus Disclosure* (**NI 81-101**), and
- Companion Policy 81-101CP *to National Instrument 81-101 Mutual Fund Prospectus Disclosure* (**81-101CP**).

We refer to the amendments to NI 81-102, and the related consequential amendments to NI 81-101 and 81-101CP together as the Amendments. The Amendments are part of Stage 3 of the CSA's implementation of the point of sale disclosure project (the **POS Project**). The text of the Amendments is included in annexes to this Notice and is available on the websites of members of the CSA.

[1] As published on December 8, 2016 "Mandating a Summary Disclosure Document for Exchange-Traded Mutual Funds and its Delivery – CSA Notice of Amendments to National Instrument 41-101 *General Prospectus Requirements* and to Companion Policy 41-101CP to National Instrument 41-101 *General Prospectus Requirements* – and Related Consequential Amendments."

We expect the Amendments to be adopted in each jurisdiction of Canada.

Subject to Ministerial approval requirements for rules, the Amendments come into force on March 8, 2017.

Substance and Purpose

We think that a mandated standardized risk classification methodology will provide for greater transparency and consistency than currently available, which will allow investors to more readily compare the investment risk levels of different mutual funds.

Background

Currently, the fund manager of a conventional mutual fund determines the investment risk level of the mutual fund for disclosure in the Fund Facts based on a risk classification methodology selected at the fund manager's discretion. The fund manager also identifies the mutual fund's investment risk level on the five-category scale prescribed in the Fund Facts ranging from Low to High.

The 2013 Proposal

An earlier version of the Methodology was published on December 12, 2013 by the CSA in CSA Notice 81-324 and Request for Comment *Proposed CSA Mutual Fund Risk Classification Methodology for Use in Fund Facts* (the **2013 Proposal**). The 2013 Proposal was developed in response to stakeholder feedback that the CSA had received throughout the implementation of the POS Project for mutual funds, notably that a standardized risk classification methodology proposed by the CSA would be more useful to investors, as it would provide a consistent and comparable basis for measuring the investment risk level of different mutual funds.

A summary of the key themes arising from the 2013 Proposal was published in CSA Staff Notice 81-325 *Status Report on Consultation under CSA Notice 81-324 and Request for Comment on Proposed CSA Mutual Fund Risk Classification Methodology for Use in Fund Facts*.

The 2015 Proposal

After considering the comments received on the 2013 Proposal, the CSA published an amended version of the Methodology on December 10, 2015 (the **2015 Proposal**) for a 90 day comment period that ended on March 9, 2016.

Summary of Written Comments Received by the CSA

We received 26 comment letters on the 2015 Proposal. We thank everyone who provided comments. Copies of the comment letters are posted on the website of Autorité des marchés financiers at www.lautorite.qc.ca and the website of the Ontario Securities Commission at www.osc.gov.on.ca. You can find the names of the commenters and a summary of the comments relating to the 2015 Proposal and our responses to those comments in Annex A to this Notice.

Generally, the majority of commenters supported the implementation of a standardized, mandatory risk classification methodology, and agreed with the use of standard deviation as the sole risk indicator to determine a mutual fund's investment risk level on the risk scale in the Fund Facts and the ETF Facts.

Summary of Key Changes to the 2015 Proposal

After considering the comments received, we have made some non-material changes to the 2015 Proposal. These changes are reflected in the Amendments that we are publishing as Annexes to this Notice. As these changes are not material, we are not republishing the Amendments for a further comment period.

The following is a summary of the key changes made to the 2015 Proposal.

- **Mutual funds with less than 10 years of history - Item 4 of Appendix F, NI 81-102**

  We are requiring a mutual fund that does not have the sufficient 10-year performance history to use the past performance of another mutual fund as proxy for the missing performance history: (i) when the mutual fund is a clone fund as defined under NI 81-102 and the underlying fund has 10 years performance history; or (ii) when there is another mutual fund with 10 years of performance history, that is subject to NI 81-102 and that has the same fund manager, portfolio manager, investment objectives and investment strategies as the mutual fund. The latter accommodation allows a corporate class version of the mutual fund or a mutual fund trust version of the mutual fund, with 10 years of performance history, to be used as a proxy for the missing performance history to calculate standard deviation under the Methodology.

- **Reference Index – Item 5 of Appendix F, NI 81-102**

  In selecting an appropriate reference index, we have clarified that each of the factors must be considered. While a mutual fund must consider each of the factors listed in Instruction (2) of Item 5 of Appendix F, NI 81-102 when selecting and monitoring the reasonableness of a reference index, we clarified that other factors may also be considered in selecting and monitoring the reasonableness of a reference index if such factors are relevant to the specific characteristics of the mutual fund.

  In providing this clarification, we acknowledge that a reference index that reasonably approximates, or is expected to reasonably approximate, the standard deviation of the mutual fund may not necessarily meet all of the factors in Instruction (2) of Item 5 of Appendix F, NI 81-102.

- **Prospectus Disclosure of the Methodology – Item 9.1 of Part B, Form 81-101F1**

  If the performance history of another mutual fund is used as a proxy, a mutual fund must disclose in the prospectus a brief description of the other mutual fund. If the other mutual fund is changed, details of when and why the change was made must also be disclosed in the prospectus.

We are now also requiring that the Methodology be available on request at no cost.

Anticipated Costs and Benefits

The Methodology was developed in response to comments we received throughout the course of the POS Project regarding the need for a standardized risk classification methodology to determine the investment risk level of a mutual fund in the Fund Facts. The Methodology will also be used to determine the investment risk level of an ETF in the ETF Facts. We think that the implementation of the Methodology will benefit both investors and the market participants by providing:

- a standardized risk classification methodology across all conventional mutual funds for use in the Fund Facts and all ETFs for use in the ETF Facts;[2]

- consistency and improved comparability between conventional mutual funds and/or ETFs; and

- enhanced transparency by enabling third parties to independently verify the risk rating disclosure of a conventional mutual fund in the Fund Facts or an ETF in the ETF Facts.

We further think that the costs of complying with the Methodology will be minimal since most fund managers already use standard deviation to determine, in whole or in part, a conventional mutual fund's investment risk level on the scale prescribed in the Fund Facts. In addition, as risk disclosure changes in the Fund Facts or ETF Facts between renewal dates are expected to occur infrequently, the costs involved would be insignificant.

Overall, we think the potential benefits of improved comparability of the investment risk levels disclosed in the Fund Facts and ETF Facts for investors, as well as enhanced transparency to the market, are proportionate to the costs of complying with the Methodology.

Transition

The Amendments will be proclaimed into force 90 days after their publication, that is on March 8, 2017. The Amendments have a transition period of 9 months after publication date so the Amendments will take effect on September 1, 2017 (the **Effective Date**). As of the Effective Date, the investment risk level of conventional mutual funds and ETFs must be determined by using the Methodology for each filing of a Fund Facts or ETF Facts, and at least annually.

[2] See footnote 1.

Publication Date (December 8, 2016)	In-Force Date (March 8, 2017)	Effective Date (September 1, 2017)
• Final publication of Amendments	• Amendments come into force	• The Methodology must be used to determine the investment risk level in the Fund Facts and in the ETF Facts

The Effective Date also coincides with the effective date for the filing requirement for the initial ETF Facts. As of the Effective Date, an ETF that files a preliminary or pro forma prospectus must concurrently file an ETF Facts for each class or series of securities of the ETF offered under the prospectus and post the ETF Facts to the ETF's or ETF manager's website.[3]

Local Matters

Annex E to this Notice is being published in any local jurisdiction that is making related changes to local securities legislation, including local notices or other policy instruments in that jurisdiction. It also includes any additional information that is relevant to that jurisdiction only.

Some jurisdictions may require amendments to local securities legislation, in order to implement the Amendments. If statutory amendments are necessary in a jurisdiction, these changes will be initiated and published by the local provincial or territorial government.

Unpublished Materials

In developing the Amendments, we have not relied on any significant unpublished study, report or other written materials.

Content of the Annexes

The text of the Amendments is contained in the following annexes to this Notice and is available on the websites of members of the CSA:

Annex A – Summary of Public Comments on the 2015 Proposal

Annex B – Amendments to National Instrument 81-102 *Investment Funds*

Annex C – Amendments to National Instrument 81-101 *Mutual Fund Prospectus Disclosure*

Annex D – Changes to Companion Policy 81-101CP to National Instrument 81-101 *Mutual Fund Prospectus Disclosure*

Annex E – Local Matters

[3] See footnote 1.

Questions

Please refer your questions to any of the following:

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