

CSA PROPOSES AMENDED RISK DISCLOSURE FOR MUTUAL FUNDS AND ETFs

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On December 10, 2015, the Canadian Securities Administrators ("**CSA**") published proposed amendments^[1] (the "**Current Proposed Amendments**") to risk disclosure requirements for mutual funds and exchange-traded mutual funds ("**ETFs**"). The Current Proposed Amendments will require mutual funds and ETFs to use a standard deviation measure of risk when disclosing investment risk levels in existing Fund Facts documents and in proposed ETF Facts documents, respectively. These amendments are expected to be proclaimed into force in late 2016 or early 2017.

Background

Currently, the Fund Facts document requires a mutual fund to provide its investment risk level based on a risk classification methodology of the fund manager's own choosing. While there is presently no disclosure document similar to a Funds Facts document required for ETFs, the CSA has proposed a document called "ETF Facts" that would serve the same purpose – see our previous bulletin on ETF Facts here.

In response to stakeholder feedback that a standardized risk classification methodology would be more useful to investors, the CSA began researching alternatives to the existing risk disclosure framework. On December 12, 2013, the CSA published an initial version of the risk disclosure amendments in which they first proposed using standard deviation as the sole indicator of risk (the "**2013 Proposed Amendments**").

The 2013 Proposed Amendments generated 56 comment letters, which were generally supportive of the proposal. The Current Proposed Amendments are largely similar to the 2013 Proposed Amendments. However, based on feedback received, the CSA made the following key changes:

- **ETF Facts.** The application of the amendments was extended to the proposed ETF Facts document.
- **Risk level categories.** The six-category risk level scale was abandoned in favour of the five-category scale currently prescribed in Fund Facts documents.^[2]
- **Discretion to increase risk level.** The investment risk level of a fund may be increased (but not decreased) if doing so is reasonable in the circumstances.
- **Required updates to risk level.** The frequency of required updates to risk level disclosure was

decreased.^[3]

- **Reference index guidance.** The 2013 Proposed Amendments contained a list of criteria for a reference index to be considered appropriate. This list of criteria was removed, but the list of reference index principles was retained and amended.
- **Fund reorganization or change in objective.** Where there has been a reorganization or transfer of assets of a mutual fund^[4] (including a fund merger), a requirement was added to calculate standard deviation based on the returns of the continuing mutual fund. Similarly, where there has been a change to the fundamental investment objectives of a mutual fund,^[5] a requirement was added to calculate standard deviation based on the returns of the fund starting from the date of the change.
- **Record-keeping.** The requirement to maintain records of the risk disclosure methodology for ten years was removed in favour of the already existing requirement in securities legislation to maintain records for seven years from the date the records were created.^[6]

Summary of New Risk Disclosure Requirements

Disclosing Risk Level

The Current Proposed Amendments would require all mutual funds, and eventually ETFs, to calculate their standard deviation using monthly returns on a 10-year historical basis.^[7] This standard deviation number would be used to place the fund into one of five investment risk levels from "Low" to "High"^[8] and this risk level would be disclosed in the Fund Facts or ETF Facts document. Records must be maintained of how the risk level of a mutual fund or ETF was determined. A fund may increase (but not decrease) its risk level if doing so is reasonable in the circumstances.

Risk level disclosure must occur at least annually, and within 60 days from the filing of a Fund Facts or ETF Facts document, or whenever the current risk level is no longer reasonable in the circumstances. The CSA would generally consider a change to the fund's risk level disclosed on the most recently filed Fund Facts or ETF Facts document to be a material change under securities legislation.

The Current Proposed Amendments do not require that risk level be determined for each series or class of securities of a fund unless a series or class of securities possesses an attribute that could result in a different risk level than that of the fund (eg. a series or class that is offered in a foreign currency or employs currency hedging may be subject to different risks).

Using a Reference Index

For mutual funds and ETFs that do not have the sufficient 10-year history, a reference index can be used as a proxy. The reference index chosen must comply with certain principles proposed by the CSA including, among

others,^[9] the following: the index returns are highly correlated with the returns of the fund, the index has a systemic risk profile highly similar to the fund, and the index reflects market sectors in which the fund is investing. In response to comments received by the CSA, the Current Proposed Amendments have removed the requirement that the reference index be "widely recognized" and "publically available" in all instances. A mutual fund or ETF must monitor the reasonableness of the reference index annually or more frequently if necessary.

In response to comments that some actively managed mutual funds are so unique that none of the widely available benchmarks capture their exposure or strategy, the CSA stated that reference index returns should be correlated to the returns of the mutual fund rather than replicate the returns exactly. The Current Proposed Amendments also permit the use of blended indices. In the CSA's view, there are sufficient reference indices available that can serve as a proxy for the risk profile of actively managed funds.

Regarding fund of funds, where the top fund does not have the requisite 10-year history and its strategy is to "clone" the bottom fund, the CSA may allow, through exemptive relief, the use of the underlying fund's standard deviation values to determine the top fund's risk level.

Why Standard Deviation?

In deciding on a standardized measure of risk, the CSA considered 15 different risk indicators before selecting standard deviation. Several benefits of using standard deviation were noted:

- Its calculation is relatively simple, well-known, and established.
- It provides a consistent risk evaluation for a broad range of funds.
- It provides a relatively stable and meaningful risk evaluation when coupled with an appropriate historical period.
- It is already broadly used in the industry and serves as the basis for the methodologies used by both the Investment Funds Institute of Canada and the Committee of European Securities Regulators.
- It is easily available from third party data providers, thereby providing a data source that allows oversight and independent verification by both regulators and investors.
- The implementation costs are expected to be minimal since most fund managers already use standard deviation, at least in part, to determine a fund's risk level.

Purpose

The purpose of the Fund Facts document and the eventual ETF Facts document is to give investors access to key information about mutual funds and ETFs in a language they can understand. The CSA believes that introducing standard deviation as a standardized risk measure will help to achieve this purpose by providing

investors with a simple way to measure risk and to make meaningful comparisons between mutual funds and/or ETFs.

The final rules implementing the Current Proposed Amendments are expected to be implemented in the Fall of 2016 and to be in force three months later. The CSA seeks feedback on the Current Proposed Amendments. The deadline for submitting comments to the CSA is March 9, 2016. Please contact a member of our Investment Funds & Asset Management Group if you have any questions or seek assistance with the preparation of a comment letter.

by Jason A. Chertin and Vlad Duta

[1] The proposed amendments are to National Instrument 81-102 Investment Funds ("NI 81-102"), National Instrument 81-101 Mutual Fund Prospectus Disclosure and its related companion policy, and National Instrument 41-101 General Prospectus Requirements and its related companion policy.

[2] The standard deviation ranges in each risk category were also changed to make them consistent with the ranges in the risk classification methodology developed by the Investment Funds Institute of Canada.

[3] Rather than monthly determinations required under the 2013 Proposed Amendments, the risk levels are now to be determined upon each filing of a Fund Facts or ETF Facts document and at least annually

[4] Pursuant to section 5.1(f), (g) or (h)(i) of NI 81-102.

[5] Pursuant to section 5.1(c) of NI 81-102.

[6] See section 11.6 of National Instrument 31-103 Registration Requirements, Exemptions and Ongoing Registrant Obligations).

[7] Standard deviation should be calculated by using net asset value (as opposed to market price).

[8] The five risk levels (along with their standard deviation parameters) are as follows: Low (0-6); Low to Medium (6-11); Medium (11-16); Medium to High (16-20); and High (20 or greater).

[9] The other principles are that the index: (i) 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; (ii) contains a high proportion of the securities represented in the mutual fund's portfolio with similar portfolio allocations; (iii) has security allocations that represent invested position sizes on a similar pro rata basis to the mutual fund's total assets; (iv) is denominated, in or converted into, the same currency as the mutual fund's reported net asset value; (v) has its returns computed on the same basis (e.g., total return, net of withholding taxes, etc.) as the mutual fund's returns; (vi) is based on an index or indices that are each administered by an organization

that is not affiliated with the mutual fund, its manager, portfolio manager or principal distributor, unless the index is widely recognized and used; and (vii) 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 distributions in additional securities of the mutual fund.

A Cautionary Note

The foregoing provides only an overview and does not constitute legal advice. Readers are cautioned against making any decisions based on this material alone. Rather, specific legal advice should be obtained.

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