New Risk Classification Methodology for Mutual Funds and ETFs — September 1, 2017 with Phased-In Disclosure

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Under new rules finalized by the Canadian Securities Administrators (CSA) on December 8, 2016, Canadian fund managers must adopt by September 1, 2017, a new prescribed risk classification methodology to determine the investment risk levels of the publicly offered mutual funds and exchange-traded funds (ETFs) they manage. Disclosure of the applicable investment risk level must be included in a fund's next prospectus filing made after September 1, 2017, although the disclosure can be made, and the methodology can be adopted, earlier.

Final amendments to National Instrument 81-102 *Investment Funds*, National Instrument 81-101 *Mutual Fund Prospectus Disclosure* and National Instrument 41-101 *General Prospectus Requirements* come into force on March 8, 2017, with a phased-in transition period. The rule amendments can be found here and here.[1]

The new risk classification methodology requires fund managers to measure the investment risk of their funds using standard deviation and to disclose that risk in Fund Facts and ETF Facts, as applicable, using a prescribed five-category scale. This concept is not new for managers of mutual funds, given that most fund managers use the guidelines for fund volatility risk classification developed by The Investment Funds Institute of Canada (IFIC) and have long disclosed risk in their prospectus documents using the same five-category scale as is now mandated by the CSA. The essential differences between the new mandatory methodology and disclosure and the IFIC guidelines are that fund managers will have far less discretion to use their business judgement when deciding in which risk category to slot their funds, and the more prescriptive nature of the CSA methodology for calculating standard deviation, particularly for funds with less than 10 years of performance history.

Under the final rule amendments:

- Fund managers must use standard deviation, calculated according to the prescribed rules, to measure the investment risk of their funds. Standard deviation must be calculated for the most recent 10 years of a fund using the monthly total returns, assuming reinvestment of income and capital gains distributions, of the series of the fund that first became available to the public. If

another series of the fund has features distinct from that series, for example, a hedged series then the fund manager must calculate and disclose the investment risk rating of that distinctive series separately.
- The investment risk level of a fund will then be determined based on the prescribed five-category scale, which depends on the applicable standard deviation range for that fund.
- Each fund's risk level must be determined at least annually, or when there is a change in circumstances that would trigger a review of the fund's risk level. Examples of such circumstances include a fund merger, a reorganization or a change to a fund's investment objectives.

Transition to the new rules can be made over time, so long as the new methodology is adopted by September 1, 2017, which requires fund managers to determine the investment risk of each fund using the new requirements "at least annually". The CSA expect that the determination of investment risk using the new methodology will be done in conjunction with the next prospectus renewal or amendment filing for each fund after September 1, 2017, which will allow for an efficient transition to the new regime. Fund managers wishing to use the new methodology and disclosure for their funds before September 1, 2017 may do so — that is, for the spring/summer 2017 prospectus renewals.

Highlights of the Investment Risk Methodology

The CSA modified the final rules from what was proposed in December 2015 in response to comments, including those of Borden Ladner Gervais LLP. Some highlights of the new rules include the following.

- "Clone" funds with less than 10 years of performance history can use the performance history of its underlying fund for the remainder of the 10-year period.
- Funds with less than 10 years of performance history may use the performance history of another fund to complete the remainder of the 10-year period if that fund has the same manager, portfolio manager, investment objectives and investment strategies and is subject to NI 81-102.
- If the performance history of another fund is being used as a proxy, a description of that proxy fund must be disclosed in the simplified prospectus of the fund using the proxy fund.
- Funds with less than 10 years of performance history (without a proxy fund) must use a reference index to complete the remainder of the 10-year period. Such reference index can be a composite of several permitted indices. If a reference index is used for the performance history of a fund, the reasonableness of such use needs to be monitored on an annual basis.
- Fund managers may, using their judgement, increase a fund's investment risk level if they think it is reasonable to do so, but may not lower a fund's investment risk level.
- The new methodology is based on historical volatility and does not predict future risk attributes.

Compliance Implications

Fund managers will need to ensure that their compliance policies and procedures reflect the new methodology and requirements. Some of the key compliance considerations include:

- The investment risk methodology adopted by the fund manager should be in writing, using the fund manager's own words (as opposed to simply cross-referring to Appendix F of NI 81-102), so long as that methodology is consistent with the prescribed rules. Any special rules applicable to a fund should be noted (for example, if a fund has a series where the investment risk is materially different from the oldest series which is used to calculate risk). It should be clearly stated that this investment risk methodology must be provided to investors who ask for it, at no cost.
- Written records of how the investment risk level of a fund is determined — on an annual basis — should be recorded and maintained, along with an explanation as to the persons responsible for carrying out this assessment, as well as testing its validity on a periodic basis. The timing of this annual assessment should be tied to the annual renewal of the fund's prospectus documents.
- When a reference index or another fund is used to complete the 10-year performance of a fund, this should be clearly indicated, along with a brief explanation as to why the index or fund is appropriate to determine the fund's investment risk.
- If a fund's investment risk level is increased, the fund manager must maintain records of why it was reasonable to do so in those circumstances.
- Fund Facts and ETF Facts documents should be updated at the next renewal (after September 1, 2017) to reflect the new disclosure requirements (see NI 81-101 and NI 41-101 amendments for mutual funds and ETFs, respectively).

If you would like further information on the final regime applicable to investment risk for mutual funds and ETFs, or would like assistance in understanding how to implement the new requirements, please contact your usual lawyer in BLG's Investment Management Group, the authors of this Bulletin or the leaders of BLG's Investment Management Group.

[1] We described the CSA's work to develop the risk methodology for investment funds in our Investment Management Bulletins released in January 2016 and January 2014. Please see *CSA Proposals Will Require Mutual Funds and ETFs to Use Standard Deviation to Disclose Risk* (January 2016) and *Canadian Regulators Propose Standard Deviation as the Mandatory Risk Measurement for Canadian Investment Funds* (January 2014). Please also see our Investment Management Bulletin on the final rules mandating ETF Facts *ETF Facts Now Required for Canadian Exchange-Traded Funds — Two-Year Phased-In Implementation* (December 2016).

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