

August, 2011

Comparing Canada's Fund Facts to IOSCO Principles of Point-of-Sale Disclosure

The IOSCO member agencies in the International Organization of Securities Commissions (IOSCO) cooperate in developing, implementing and promoting adherence to internationally recognized and consistent standards of regulation, oversight and enforcement in order to protect investors, maintain fair, efficient and transparent markets, and seek to address systemic risks. Canada is represented at IOSCO. In early 2011 IOSCO released the FINAL version of *Principles of POS disclosure*

<http://www.iosco.org/library/pubdocs/pdf/IOSCOPD343.pdf>

Principles of POS disclosure contains a number of principles and best practice for mutual fund point-of-sale disclosure. The stature of IOSCO is such that even one non-compliance with its standard merits scrutiny and concern. In this report we compare the Canadian Securities Administrator's Fund Facts disclosure with the IOSCO *Principles of POS disclosure* to assess the degree of compliance.

According to IOSCO, new POS disclosure requirements should not be imposed without the benefit of consumer testing or assessment to help determine the likely effectiveness of new disclosure requirements. The document points out that research indicates that retail investors exhibit a range of behaviours and biases in the decision-making process, including acting on emotion, rather than on facts. They argue that these behaviours should be understood and considered to the greatest degree possible when developing a regulatory approach. The research referenced suggests that retail investors focus on information about investment returns or past performance in an attempt to answer the question "how much can I make?." They do not, however, focus only on returns. They also want to know about risks and guarantees in an effort to understand how much they might lose. Finally, they want to know about the costs. They are interested in the fees and expenses, although evidence is more mixed on the extent to which investors take costs into account.

The Report points out that focus groups alone may not be the most effective way to test the usability of a document, or to learn how well an individual really understands what is written. In the development of Fund Facts, the CSA used focus groups which we feel provide unreliable results.

IOSCO provides the following as the recommended key disclosure content and sequence:

- ⤴ objectives and investment strategies;
- ⤴ "risks (e.g., relating to the potential negative performance of the investment, or even broader risks and their variability, such as liquidity risks e.g. redemption restrictions, lock-up periods, gates, etc; counter-party risks when there is some capital protection or guarantee; operational risks; etc);
- ⤴ "past performance (which may be presented in a graphical or tabular manner, and may be standardized between CIS') or, where past performance is not available, potential return scenarios;



- ⤴ "costs (e.g., subscription or redemption fees, annual management charges (AMC), miscellaneous expenses or indeed composite measures such as the Reduction in Yield (RIY) or Total Expenses Ratio (TER)); and
- ⤴ "conflicts-of-interest which could include both conflicts arising within the fund manager, and those affecting the distributor or intermediary (this could include disclosure of the conflict itself and the mitigation strategy).

Of particular concern to IOSCO are compensation arrangements between intermediaries and product producers that may influence the advice provided by the intermediary to a retail client. These arrangements may create a direct financial incentive to sell particular products because they offer higher compensation for the intermediary.

On page 28 of the IOSCO Report we find the following :

"Its risk and reward profile. Risk disclosures should include the material risks for the product. This may include performance risk/volatility, credit risk, liquidity risks and operational risks. In some jurisdictions, a scale may be considered appropriate to identify the overall risk measurement or classification of the product, rather than a list of specific product risks, and this may be accompanied by appropriate narrative explaining how to interpret the scale. This may assist with risk comparisons, although regulators and investors need to be aware of the inherent limitations in such measures. Regulators might wish to include supporting information indicating minimum length of holding relative to short term volatility, what types of "targeted investors" the product is being marketed to and what commitment those investors need to make."

So, how does Fund Facts stack up?

Principle 2 of the IOSCO standard states "*Key information should be delivered, or made available, for free, to an investor **before the point of sale**, so that the investor has the opportunity to consider the information and make an informed decision about whether to invest.*" The CSA's original intention was to be compliant. However, due to some industry objections, this has been deferred for additional consultation. As it stands, Fund Facts will be delivered two business days AFTER the purchase has been made. According to experience and behavioural finance research, this dramatically reduces the chances that document will be read by retail investors. **In effect, there will be minimal disclosure using Fund Facts, making the document non-compliant.**

Fund Facts provides a five point word scale running from Low to High. It is based on, *in most cases*, the short term variability of fund returns (standard deviation) . It is labeled as "How risky is it?" but it is really only volatility risk as determined by a risk classification system ("the Voluntary Code") developed without public comment by fund industry lobbyist, the Investment Funds Institute of Canada (IFIC) . In a June 24, 2011 article publicly posted at *fundlibrary.com* entitled "Always take a second look at mutual fund risk ratings PART 2", the author reports on the results of comparing fund volatility with the risk rating assigned by the company. The result: Out of the 1,497 funds analyzed, only 974 had a Standard Deviation (SD) that fell within the band assigned to the risk rating i.e. close to 35% had a prospectus risk rating that did not align with IFIC's Voluntary Code and nearly one out of 10 (9.9%) of all funds analyzed, had a volatility that was above the



recommended SD band for its risk rating. Thus, it is not reasonable to assume a certain level of volatility simply by choosing a mutual fund within a particular IFIC risk category. To the extent retail investors use this scale, their decisions will not be informed ones. This may prove to be costly if unsuitable investments are purchased.

We add parenthetically that the IFIC volatility risk classification Document, while necessary to truly understand the scale, is not filed on SEDAR or generally available for public use. Therefore, it is impossible for even a determined retail investor to really understand what risks he/she is exposed to.

IOSCO Principle 3 requires that "*Key information should be delivered or **made available** in a manner that is appropriate for the target investor*". **Fund Facts is clearly non-compliant since a key Prospectus incorporated document, the IFIC Voluntary Code, cannot be obtained.**

In Europe, the "Risk and reward profile" section of the key investor information document contain a synthetic indicator [a scale], supplemented by: (a) a narrative explanation of the indicator and its main limitations; (b) a narrative explanation of risks which are materially relevant to the Undertakings for Collective investment in Transferable Securities (UCITS) and which are not adequately captured by the synthetic indicator. **Fund Facts does not contain any narrative of these risks.**

The CSA has not defined a standardized methodology for the risk scale so in principle (and practice) each fund firm could use a scale of their own design. It is left to investors to request a copy of the Simplified Prospectus and figure out the validity of the methodology. Fund Facts does not include supporting information indicating minimum length of holding relative to short term volatility, what commitment the investors need to make or a list of the principal risks of the fund. **Fund Facts does not provide any guidance on how to interpret the scale.** Thus, investors are misled by the CSA disclosure and are unable to compare between fund companies because of differing scale preparation methodologies. If they do compare, the results could very likely be meaningless or worse. **This is non-compliant with IOSCO Principle 4** which states "*Disclosure of key information should be in plain language and in a simple, accessible and comparable format to facilitate a meaningful comparison of information disclosed for competing [Collective Investment Scheme] CIS products*".

The "How has the fund performed?" section of Fund Facts contain a weak warning "It's important to note that this doesn't tell you how the fund will perform in the future." IOSCO requires that past performance disclosures should include a warning that historical performance is not an indicator of future performance. IOSCO specifically states that if key information contains disclosures on past performance, regulators should consider imposing requirements designed to reduce the potentially misleading focus on past performance. A stronger warning that has been suggested by investor advocates that can be much more effective "Do not expect the fund's quoted past performance to continue in the future. Studies show that mutual funds that have outperformed their peers in the past generally do not outperform them in the future. Strong past performance is often a matter of chance." IOSCO is acutely aware that investors are overly influenced by strong or poor recent past performance or false reference points and that's why they locate risk disclosure in front of



performance on disclosure documents. **The CSA does not follow the IOSCO format** - in fact, it does the opposite by putting performance ahead of risks, increasing the chance investors will chase recent returns.

As regards disclosure of conflicts-of-interest, Fund Facts says "*Investment firms may pay part of the trailing commission to their representatives*". IOSCO requires disclosure of any conflict-of-interest that can give intermediaries and their personnel a financial incentive to sell particular funds or share classes in breach of their duty to act in the best interest of their client, as well as any non-monetary benefits provided to intermediaries. **We do not regard the CSA disclosure to be responsive to the IOSCO standard.** The SEC Fund Summary Prospectus disclosure is a good example of a Best practice and it clearly follows IOSCO guidelines.:

"Payments to Broker-Dealers and Other Financial Intermediaries. If you purchase the Fund through a broker-dealer or other financial intermediary (such as a bank), the Fund and its related companies may pay the intermediary for the sale of Fund shares and related services. These payments may create a conflict of interest by influencing the broker-dealer or other intermediary and your salesperson to recommend the Fund over another investment. Ask your salesperson or visit your financial intermediary's Web site for more information."

It is immediately obvious that the US disclosure specifically spells out a potential conflict-of-interest while **Fund Facts evades the key issue and thus is non-compliant with the IOSCO standard** which requires that disclosure documents should not obfuscate important items, including warnings, or seek to diminish their importance. IOSCO Principle 6 clearly states : "*In deciding what key information disclosure to impose on intermediaries and product producers, regulators should consider who has control over the information that is to be disclosed*". In Canada, the dealer representative ("salesperson") has control, making the weak disclosure yet another risk of mutual fund investing .

Where IOSCO is silent on an aspect of disclosure, the CSA document has chosen a weak disclosure. For example , the % holding of the top 10 securities held by the fund is provided by the U.S. Summary Prospectus but Fund Facts only lists the names of the companies. Inclusion of the percentages would be an aid in assessing concentration risk.

In Japan, the *Financial Instruments and Exchange Act* requires a "document before concluding a contract" that contains a statement that the company is a financial instruments firm; and the registration number; the name of the self regulatory organization (SRO) of which the firm is a member., an outline of the contract and any fees; a warning concerning potential losses as well as information concerning applicable taxes, cancellation rights (*cooling off* period), and fund contact information. We regard this as a much stronger measure of protection than the Fund Facts disclosure regime.

Conclusion

Fund Facts is non-compliant with IOSCO standards in a number of important disclosure elements. Where the IOSCO standard is silent, the CSA document has chosen the weakest alternative. We conclude that Fund Facts provides deficient, incomplete, inconsistent and misleading information. These defects are of such a scale that Fund facts can cause investor harm. This is against a backdrop where OBSI is under attack by several investment dealers, seniors are a growing proportion of the fund investor base and markets



are extremely volatile. These are conditions for the Perfect Storm. We therefore urge Regulators and those with oversight of regulators not permit Fund Facts to proceed until the numerous deficiencies, non-compliances and issues are satisfactorily resolved.

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