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Ladies and Gentlemen:

Morningstar Research, Inc. ("Morningstar Canada") welcomes the opportunity to comment on the CFR Conforming Changes to MSN-0069 (Suitability) dated June 21, 2021.

Morningstar is a leading provider of independent investment research; our mission is to create products that help investors reach their financial goals. Morningstar's ongoing evidence-based research efforts into investor behaviour are complemented by our academically validated risk profiling and financial planning processes. Because we serve individual investors, professional financial advisors, and institutional clients on a global scale, we have a multifaceted perspective on the impact of the proposed guidance and its possible effect on the advice that investors receive. Moreover, we have experience providing solutions addressing the global shifts in regulation toward a best interest standard and offer a unique opinion on the know-your client (KYC), know-your-product (KYP), and suitability requirements.

We appreciate that the guidance provided through this bulletin is in line with the principles-based nature of the client-focused reforms; however, we also believe that MFDA members can benefit from more-refined detail to help ensure that the acts of collecting KYC information and applying a suitability determination are meaningful and result in a better outcome for the investor.

Elements of a Risk Profile

MSN-0069 Section 1 F clearly delineates between risk tolerance and risk capacity. The section further explains that properly assessing a client's risk capacity or capacity for loss involves knowledge of "financial circumstances, (including liquidity needs, debts, income and assets), and how much of a client's total investments an account or particular investment position represents, and the client's age and life stage."

Although the prior section (MSN-0069 Section 1 E) references time horizon explicitly, we believe that time horizon should be mentioned again in Section 1 F. Without time horizon, an assessment of risk capacity cannot be conducted.

Additionally, we believe the guidance should include other elements to paint a clear picture of a client's risk profile. It is important to note these elements in an effort to encourage best practices. Although members are obliged to consider both risk tolerance and risk capacity, when acting in the client's best interest, it may require the consideration of other aspects as well. The below definitions are paraphrased from a consultation with the Ontario Securities Commission's Investment Advisory Panel in 2015, by Brayman[1] et al. which references Nobre and Grable's

[1] https://www.osc.ca/sites/default/files/2021-02/iap_20151112_risk-profiling-report.pdf

2015 work, "The Role of Risk Profiles and Risk Tolerance in Shaping Client Investment Decisions," and separate objective, subjective, and external factors.

Objective Factors:

Risk Capacity:	The financial ability of a client to endure any potential financial loss.
Risk Need:	The amount of risk that should be expected in order for a client to meet specific financial goals. Larger goals may require higher returns on investment that come at the cost of higher risk.

Subjective Factors:

Risk Tolerance:	The willingness of the client to take on risk. It can be defined through one's attitude toward risk and is often described as a high/low risk tolerance.
Risk Aversion:	The disinclination or dislike a client has toward risk. A risk-averse individual is made uneasy by and unlikely to engage in any risky behavior. Risk Aversion can be viewed as an antonym to Risk Tolerance.
Loss Aversion:	This relates to prospect theory and the fact that investors often put a greater weighting on avoiding outsize losses over producing outsize gains. Clients may tolerate the swings in the market (risk tolerance) so long as they remain above a 'reference point'; however, should portfolio values swing below said point, investors are prone to having adverse reactions.
Risk Composure:	This is the likelihood that clients in a perceived crisis will behave fundamentally different from their rational self and may take action that could crystalize losses. It can be measured based on past decisions.
Risk Preference:	A client uses a combination of subjective and objective cognitive evaluations to generate a Risk Preference. There may not always be justification for the individual's feelings regarding preferences.

External Factors:

Risk Perception:	A judgment that the client feels toward the severity of risk in association with the broader economic environment. This perception can be heavily influenced by the media and/or through lack of understanding of the risks. The influence of Risk Perception and ambiguity aversion may be reduced by greater financial literacy, education, or experience.

Collectively, the above factors culminate in a more complete risk profile. The fear in only referring to risk tolerance and

capacity is the potential to limit collection of KYC information to bare minimums that may turn a questionnaire into a 'check the box' exercise, which is not the intent of the KYC process.

The MFDA's guidance captures elements of a risk profile at a broad level but does not specify which inputs will contribute to a client's risk tolerance as opposed to risk capacity. Given the often nuanced and sometimes subjective nature of these factors, the use of some more-explicit examples or explanations could be of value.

- Liquidity needs reflect the need for the client to use a portion of their investment assets, usually to support a financial goal. If funds must be liquidated in a financial downturn to support these goals, it can lead to an accelerated depletion of investment assets from which the client cannot recover even when the markets do, leaving them potentially underfunded for the balance of their goal. This is the essence of capacity for loss.

- Questions having to do with a client's acceptance of a drop in portfolio value fall under risk tolerance, unless the client must withdraw money during these periods, which makes it a risk-capacity issue. The point is not the decline in portfolio value, but how much the client was obliged to liquidate during depressed investment values and the long-term impact it has on their goals (more in the following section). There may not be proper clarity without appropriate guidance on this difference.

- Debt is important as the servicing of debt is a nondiscretionary expense for the client and helps sets the minimum acceptable funding levels.

- Income that supports the goals, like Canadian Pension Plan payments, Old Age Security, or a defined-benefit pension, provides resources that are not subject to market volatility, allowing for increased capacity for the client. This is not the same as income during the accumulation stage for a client.

We appreciate that the regulation is not designed to be prescriptive but feel guidance to help clarify a common and more complete understanding is important.

Delineating Severity of Failure in Measurement Risk Capacity

When calculating a measure for risk capacity, our research[2] points to the need for delineation in *severity* of failure. There is a stark difference between a catastrophic failure scenario (for example, where an investor significantly outlives their capital and cannot support nondiscretionary spending) and a scenario where there is a gap between target income and what the portfolio is able to support inclusive of capital withdrawals. In the latter scenario, cost mitigation through the adjustment of discretionary spending can facilitate increased capacity.

The downfall of framing risk capacity as 'the ability to withstand losses' is that it alludes to a pass/fail scenario. In reality, an investor who has withstood a bear market and continues to stay invested will likely not have lost value in their portfolio after the recovery period. Rather, they exhibit a lower annualized rate of return. When determining a client's capacity for risk, it is imperative that the 'depth' of this gap is assessed as opposed to a simple pass/fail analysis. The former analysis adds clarity to potential portfolio outcomes and will aid in setting or resetting of goals. If this gap isn't assessed properly and analysis is limited to a pass/fail scenario, the advisor risks putting a client in an overly conservative asset allocation.

[2] https://academyfinancial.org/resources/Documents/Proceedings/2011/B2-Brayman.pdf

Supportable and Reliable Questionnaires

MSN-0069 Section 1 F states that 'the process for developing a client's risk profile should be supportable and reliable. Tools such as questionnaires can be useful to assess a client's risk profile but should be properly designed.' It is our opinion that the definition of 'supportable and reliable' is vague and can benefit from concrete guidance.

A reliable process should yield results that are (1) consistent over time regardless of market conditions and (2) include the capability to detect and flag conflicting answers such that an advisor can further clarify with a client when such incidents occur, as called for in NI 31-103 and its companion policy. With regard to consistency, risk tolerance assessments that that are correlated with short-term market performance (positive or negative) are dangerous for clients and advisors. Tests that result in inconsistent measures can result in placing a client in an asset allocation that is too conservative (in the case where the questionnaire is applied during market drawdown periods) or too aggressive (in the case of a bull market). Both situations are a detriment to the investment outcomes for the client. Hence, we urge the MFDA to include guidance around the consistency of a client's risk profile as a benchmark of a properly designed questionnaire. If it is found that risk tolerance changes as market conditions do, the design of questionnaire itself should be revisited.

Morningstar recognizes that the MFDA has provided guidance[3] on what might be included in a risk tolerance questionnaire through an illustrated sample. It can be argued that this sample questionnaire on a stand-alone basis is supportable but not necessarily reliable. Reliability is confirmed through a scientifically validated process that can be substantiated through the collection and comparison of sample data. A test of reliability should generate evidence that results are consistent over time. As such, we encourage those firms using the MFDA's sample questionnaire or its derivatives to validate results to ensure that it is indeed reliable over time.

The benefits of a truly supportable and reliable KYC process far outweighs the costs of proper design, not only through the reduced legal risks to the firm and advisor but also through the reduction of portfolio turnover during market drawdown periods.

Suitability

MSN-0069 provides guidance to members on suitability in a manner that is far less prescriptive than the prior version of guidance. Here, members receive little guidance on what would constitute a suitable recommendation aside from assuring that both KYP and KYC information is collected and the frequency at which it must be updated. The text calls for a 'demonstration of suitability,' which itself does not specify a definition.

In our opinion, a demonstration of suitability should include evidence-based structured thinking around the relationship between a client's risk profile and asset allocation. The approach should be applied consistently across a book of business and backed by sound research methodologies. The methodologies being employed should be well documented and understood by the advisor and potentially the investor.

Quantifiable scores for both a client's risk profile and a risk score for a proposed allocation would be useful tools to consider and are prevalent in the industry. However, we caution that these respective scores can often stem from disparate methodologies and can be of different scales. For example, a client risk score of '50' does not equate to a 50/50 equity/fixed-income asset mix. The essence of suitability is the translation of these scores.

[3] https://mfda.ca/ipq/

We understand that the principles-based nature of the guidance allows room for professional judgment. However, on this topic we urge the MFDA and the industry as a whole to aspire to a higher standard above and beyond professional judgment.

Measuring Portfolio Risk

In Morningstar's consults with industry participants, we recognize that several members rely largely on the 'risk level' that is defined by the Canadian Securities Administrators[4] as measure of a product's riskiness. We caution that relying solely on this level (which is, in essence, a 10-year standard deviation of returns) may systematize unwanted behavior due to the nature of the measure, given the KYP obligations and required consideration of an investment's risk. On a stand-alone basis, the measure fluctuates with the market and does not factor in the correlation between different asset classes.

The below table outlines a short study looking at rolling 10-year trailing standard deviation of afterfee returns on an annual basis over the past six years for a universe of 1,076 mutual funds and exchange-traded funds with inception dates prior to July 31, 2005. A risk level was assigned to each fund in line with the CSA's guidelines (that is, a fund with a 10-year standard deviation of 8 would receive a 'Low to Medium' risk level). The study summarizes the number of times over the six years between July 2015 and July 2021 where the conceptual 'risk level' would have changed because of the breach of risk level thresholds. For example, among the 252 allocation products studied, 69 (27%) would have changed risk levels twice over the span of six years if we observed the level in July of each year.

Exhibit 1 Study of Trailing 10-Year Standard Deviation Changes, 2015-21, Canada-Domiciled Mutual Funds and ETFs

# of Risk Level Changes	0	1	2	3	Total
Equity	224	219	167	11	621
Fixed Income	118	11	10	2	141
Allocation	157	26	69		252
Money Market	62				62
Grand Total	561	256	246	13	1076

Source: Morningstar Research Inc. | 10-Year Standard Deviations Captured July 31, 2015-21 | Oldest Share Class Only | Excludes merged and liquidated funds.

It is unlikely that 27% of surviving allocation funds changed their mandates twice over the above time frame. As such, if members rely only this measure of product risk and in turn make recommendations to modify the portfolio, the process may act as a mechanism to crystallize losses, in particular during bear markets when risk level is more likely to increase and trigger an advisor to make changes in a client portfolio.

The effects of reliance upon this measure can potentially result in structural consequences at the firm level, given that KYP requirements also require firms to monitor their product shelves for significant changes, of which a change in risk level might be considered as such.

Finally, we point out that the global financial crisis is often viewed as a 'black swan' event. Our research[5] indicates that large market corrections like this happen for domestic equities far more frequently than investors care to

[4] https://www.osc.ca/sites/default/files/pdfs/irps/ni_20161208_81-101-81-102_csa-mutual-fund-risk.pdf
[5] https://www.morningstar.com/features/what-prior-market-crashes-can-teach-us-in-2020

remember. The duration of the recovery period after market drawdowns, combined with the severity of market drawdowns, ties heavily into a client's risk capacity, neither of which are captured in a calculation of the 'risk level.'

We recommend members and firms look to utilize risk methodologies whose ratings and scores are decoupled from short-term market volatility and, hence, better represent not only the intent of the fund but also the best interest of the investor. We also note that the MFDA's prior version of guidance pointed to an improper method to weight risk ratings. This prior guidance was useful and explicit, and we hope that the MFDA considers expanding on this type of guidance in the future.

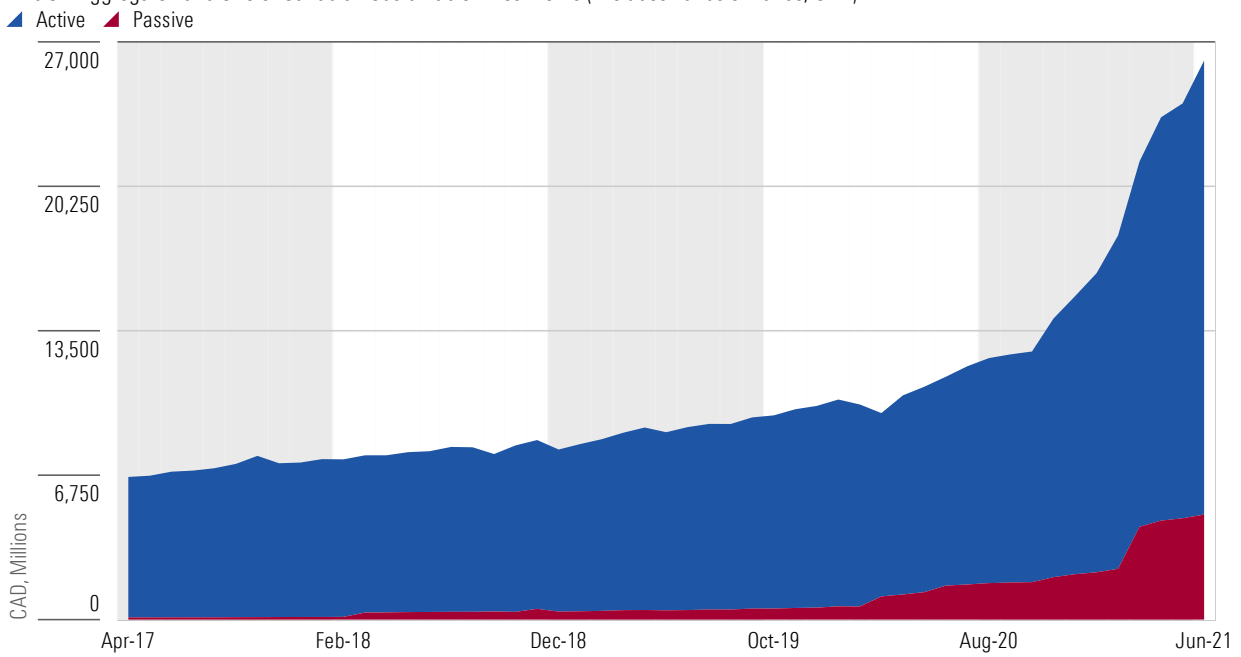
Nonfinancial Preferences (ESG)

If the intent of the client-focused reforms is indeed to put the client's interests first, then a complete investor profile would include their desire to invest in line with their values and beliefs and intention to invest sustainably.

Although at present there is no guidance or formal regulation from the CSA in regard to identifying and classifying sustainable investments, we do not believe that this should preclude MFDA members from ensuring that preferences to invest in these types of products is captured in the KYC process. In addition, environmental, social, and governance risks can often be financially material, and consideration of said risks would be a prudent consideration especially if a client has a preference in investing sustainably.

According to Morningstar's data, the assets invested in sustainable mutual funds and ETFs from Canada-domiciled fund manufacturers at the end of the second quarter of 2021 totaled CAD 26 billion, representing a year-over-year growth in assets of 130%. We expect that retail demand for investing sustainably will continue to rise exponentially in Canada.

Exhibit 2 Aggregate Fund Size of Canadian Sustainable Investments (Excludes Funds of Funds, CAD)



Source: Morningstar Direct. Data as of June 30, 2021. Excludes funds of funds.

Our data also indicates that globally, mutual funds and ETFs that follow a sustainable mandate (according to their

prospectuses) have performed in line with their nonsustainable counterparts on an afterfee basis. Locally, of the 38 sustainable funds with a 10-year track record from Canada-domiciled fund companies, 21 have outperformed respective category peers on an afterfee basis.

Exhibit 3 10-Year Net Returns vs. CIFSC Category Average, Canada-Domiciled Sustainable Investments, CAD

	1st Quartile	2nd Quartile	3rd Quartile	4th Quartile	Total
Allocation	4	4	5	3	16
Canadian Equity Balanced	2				2
Canadian Fixed Income Balanced		1			1
Canadian Neutral Balanced		1			1
Global Equity Balanced	2	1	1	1	5
Global Fixed Income Balanced			2		2
Global Neutral Balanced		1	2	1	4
Tactical Balanced				1	1
Equity	5	5	3	6	19
Canadian Equity	2	1	1	1	5
Canadian Focused Equity				2	2
Canadian Small/Mid Cap Equity		1			1
Global Equity	2	3	1	2	8
International Equity			1		1
US Equity	1			1	2
Fixed Income	3				3
Canadian Fixed Income	2				2
High Yield Fixed Income	1				1
Grand Total	12	9	8	9	38

Source: Morningstar Research Inc. | Data as of July 31, 2021 | Universe: Mutual Funds and ETFs, Oldest Share Class Only.

A possible argument against the use of sustainable investments in other jurisdictions is the perception that sustainable products are more expensive. If a product charges a higher management expense ratio for an ESG-related feature, placing a client in said product may not be in their best interest. This said, there is no evidence that this is the case in Canada. Based on October 2020 data, it was found that sustainable funds and ETFs from Canada-domiciled fund manufacturers exhibited asset-weighted median management expense ratios that are close to or in line with nonsustainable funds.

Exhibit 4 Asset-Weighted Median Management Expense Ratio (%), Sustainable vs. Traditional Investments

Broad Asset Class	Sustainable Investments	Fund Count (All Share Classes)	Traditional Investments	Fund Count (All Share Classes)
Allocation	2.09	84	1.98	5952
Equity	1.06	261	1.13	9461
Fixed Income	0.61	15	0.50	1801

Source: Morningstar Research Inc. | Data as of Oct. 13, 2020 | Universe: Mutual Funds and ETFs, Canada-Domiciled.

It can also be argued that retail consumers who invest in portfolios that are in line with their personal values are more likely to remain invested during market drawdown periods, resulting in better long-term outcomes. This was observed in Canada during the COVID-19 pandemic sell-off in March. According to Morningstar's data, while traditional mutual funds and ETFs experienced net outflows close to CAD 13 billion in March 2020, funds that Morningstar identified as sustainable (ESG funds, impact funds, and environmental sector funds) experienced net *inflows* of CAD 646 million. Given that the size of the sustainable fund market in Canada is still small (roughly 1% of total assets), the trajectory of inflows during the most recent sell-off shows anecdotal evidence that this is true in our market.

Hence, we believe that capturing a client's preference toward responsible or sustainable investments would be of no detriment to the investor, would allow for a more meaningful relationship between the client and the advisor, and would further encourage capital flow into sustainable projects in the future. We urge the MFDA and its members to consider this in the collection of KYC information. Additional benefits will surface as the industry continues to push for enhanced ESG-related disclosures from security issuers and a framework for investment funds to disclose their approaches, leaving the MFDA and its members well-prepared to service clients in this regard.

Sincerely,

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