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March 1st 2019

Delivered by Email

TO:
Dear Sirs/Mesdames:
The Secretary
Ontario Securities Commission
20 Queen Street West
22nd Floor
Toronto, Ontario
comments@osc.gov.on.ca

RE: Response to OSC notice and request to reduce regulatory burden for Ontario market participants - OSC Staff Notice 11-784: *Burden Reduction*.

This letter is submitted on behalf of CIBC World Markets Inc. ("**CIBC**" or "**we**"), in response to the Request for Comment on OSC Staff Notice 11-784: *Burden Reduction*. In particular, this memo sets out three areas of concern to the recently amended National Instrument 81-102 – *Investment Funds* ("**NI 81-102**"), which we and our clients believe perpetuate cost and administrative burdens for alternative mutual funds and their investors. This memo also sets out our proposed recommendations for addressing these areas of concern and alleviating the resulting burdens. The specific areas of concern are as follows:

1. Restricting leverage mix flexibility;
2. Lack of clarity regarding re-hypothecation; and
3. Limiting each fund to only one custodian

Item 1: Restricting leverage mix flexibility

Reference in NI 81-102: Section 2.6 (cash borrowing), Section 2.6.1 (short selling), Section 2.6.2 (combined limit on cash and short selling), Section 2.9.1 (leverage limit).

Recommendation:

- Remove borrowing limit in Section 2.6.2 of NI 81-102, which limits the aggregate value of cash borrowed combined with the aggregate market value of securities sold short to 50% of an alternative mutual fund's NAV (the "**50% Borrowing Limit**");

- Maintain the absolute leverage limit in Section 2.9.1 of NI 81-102, which limits an alternative mutual fund's exposure to cash borrowing, short selling and specified derivatives transactions to 300% of the fund's NAV (the **"Leverage Limit**"); and

- Permit the investment fund manager ("**IFM**"), as the fiduciary of the fund, to determine the best course of action when gaining financial exposure up to the Leverage Limit based on the fund's strategy and the conditions of the market (e.g. ease of execution, cost, operational structure, etc.).

Analysis: The 50% Borrowing Limit unnecessarily restricts an IFM's ability to determine the optimal method for achieving a fund's desired financial exposure. While the Leverage Limit permits an alternative mutual fund to lever up to 300% of its NAV, the 50% Borrowing Limit implies that the remaining 250% of permitted leverage must arise from specified derivatives. Rather than imposing rigid leverage mix parameters on an alternative mutual fund, the IFM should be granted the flexibility to determine the optimal leverage mix for the following reasons:

First, NI 81-102 imposes additional cost and/or operational burdens on funds where the 50% Borrowing Limit prohibits a preferable (or more cost effective) leverage combination.[1] Depending on the fund's strategy and the conditions of the marketplace, cash borrowing, short selling and specified derivatives transactions each have their own respective pros and cons. For example, in our experience, alternative investment managers generally use cash product (margin) to execute Canadian and US strategies while synthetic methods (derivatives) are more commonly used for strategies outside of Canada and the US.

Second, we are unaware of a justification for why specified derivative transactions would be less risky than cash borrowing or short selling.

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[1] See ***Appendix "A"***, which sets out a specific example of how the 50% Borrowing Limit imposes an operational burden on an Alternative Mutual Fund that would not be imposed on a private hedge fund with the same strategy.

Item 2: Re-hypothecation

Reference in NI 81-102: N/A

Recommendation**:**

- Staff to specify parameters whereby re-hypothecation would be permitted, such as:
  - Mandating that prime broker counterparties be registered as dealers and/or qualified to act as a custodian or sub-custodian in order to re-hypothecate assets;
  - Requiring that the IFM enter into a written agreement with each counterparty governing the terms of the re-hypothecation; and/or
  - Mandating that the IFM satisfy certain capitalization thresholds.

- IFM, as fiduciary of the fund, to select permitted counterparties and to ensure that collateral management methodology with each counterparty is robust and provides the appropriate protection for the fund.

Analysis: The lack of clarity surrounding the extent in which an investment fund may permit the re-hypothecation of its assets creates confusion in the marketplace and imposes unnecessary costs on such funds. Re-hypothecation is not explicitly addressed by NI 81-102. As a result, the marketplace is left to rely predominantly on a paragraph in the April 2015 edition of the *Investment Funds Practioner* (the "**2015 IFP Response**") for regulatory guidance on the issue. [2] The 2015 IFP Response speaks to re-hypothecation in the context of collateral deposited by an investment fund in respect of an OTC derivatives transaction. The limited scope of the 2015 IFP Response has caused confusion for IFMs with respect to the degree in which the 2015 IFP Response should be extrapolated to capture re-hypothecation in other contexts. In effect, IFMs adopting an interpretation of the 2015 IFP Response that is broader than current market practice are unable to most-efficiently utilize their fund's assets and are put at a competitive commercial disadvantage.

In our view, any re-hypothecation limitations imposes an unnecessary opportunity cost on investment funds, as the re-hypothecation concerns raised in the 2015 IFP Response (e.g. counterparty credit risk) may be mitigated by instead mandating that prime brokers satisfy certain baseline criteria. For example, to the extent that prime brokers are already subject to IIROC rules and regulations[3], they would be required to segregate and could not re-hypothecate

[2] See the article titled "Re-hypothecation of Collateral for OTC Derivatives" in the April 2015 edition of The Investment Funds Practitioner. This article was later affirmed by the OSC in the March 2018 edition of the Investment Funds Practioner as the OSC's only public guidance on the issue.
[3] See ***Appendix B*** for a more comprehensive summary of the relevant regulatory framework.

fully-paid securities. Such regulations would thereby eliminate the potential for a Lehman Brothers scenario whereby substantial amounts of fully-paid client assets were re-hypothecated and non-recoverable following Lehman's bankruptcy. Ultimately, once Staff has determined the minimum acceptable prime-broker criteria for re-hypothecation, we believe that the IFM (as the fiduciary of the fund) would be in the best position to select the appropriate prime broker and weigh the respective benefits of re-hypothecation against the risks.

Item 3: Requirement to have only one custodian per Fund

Reference in NI 81-102: Section 6.1 of NI 81-102

Recommendation**:**

- Remove the requirement in Section 6.1 of NI 81-102 that an alternative mutual fund should only have one custodian (the "**Single-Custodian Requirement**"), providing each prime broker of the fund: (i) qualifies as a custodian under NI 81-102; and (ii) complies with the obligations of a custodian thereunder; and

- Insert a requirement that an alternative mutual fund must have only one Fund Administrator and Unitholder Record Keeper.

Analysis: The Single-Custodian Requirement should be removed for the following reasons:

1. There is no advantage to an investment fund having only one custodian custody its assets. While a custodian under NI 81-102 has historically performed other services that are best executed by solely one entity, such as the services of a Fund Administrator (i.e. striking the NAV of the Fund) or the services of the Unitholder Record Keeper (i.e. providing the value of each unit), these services are mutually exclusive from the custodying of assets. For example, while the services of a Fund Administrator or a Unitholder Record Keeper each impact the valuation of the fund and require one unequivocal determination, assets can be custodied by multiple entities largely independently and without prejudice to one another. For this reason, many private hedge funds have operated seamlessly with numerous prime brokers custodying assets, but solely one Fund Administrator and Unitholder Record Keeper to strike the NAV and determine the value of each unit.

2. The Single-Custodian Requirement places unnecessary operational and cost burdens on alternative mutual funds, as it restricts a fund's relationship with a prime broker that is not the designated custodian or sub-custodian of the fund. In particular, Section 6.8.1(1)(b) of NI 81-102 prevents an alternative mutual fund from depositing (in connection with a short sale) portfolio assets exceeding 25% of NAV with a prime broker that is not the fund's custodian. This may require the IFM to either: (i) unwillingly enter into additional prime broker relationships (which may not be as favorable); or (ii) enter into sub-custodial relationships with each such prime broker (adding further costs and operational complexities). [4]

[4] See ***Appendix C*** for financing/custody structures that are currently available to Alternative Mutual Funds (liquid alternatives) within and outside of Canada.

We appreciate the opportunity to provide comments on this important OSC initiative. If you should have any questions on our comments, please do not hesitate to contact me at (416) 956-6118.

Yours truly,

Robert Lemon, CFA
Executive Director
CIBC World Markets Inc.

Appendix A – Example of impact of 50% Borrowing Limit:

Given:

- Borrowing of cash and securities via margin facility limited to 50% of NAV (prime brokerage facility)
- Leverage limited to three times. Defined as sum of (short cash, short securities, notional size of derivatives (less derivatives used for hedging)) over the NAV
- IFM wants to execute a market neutral strategy that is 200 long, 100 short

Steps needed (from a balance sheet perspective)

Example 1 - How an alternative investment manager would execute the trade for a private offering

#	Action	Assets			Liabilities	Equity	Off Balance Sheet Exposure	Leverage
		Cash	Securities	Total				
1	Place $100MM in account (seed money)	100	0	100	0	100		
2	IFM buys $100MM in securities	0	100	100	0	100		
3	Short sell $100MM of securities (generates $100MM in cash proceeds) - borrowed via a margin account	100	100	200	100	100	0	100%
4	IFM buys $100MM in securities	0	200	200	100	100	0	100%

Result: ease of execution to implement strategy - 100% leverage (all via margin facility)

Example 2 - How an alternative investment manager would execute the trade for an Alternative Mutual Fund

#	Action	Assets			Liabilities	Equity	Off Balance Sheet Exposure	Leverage
		Cash	Securities	Total				
1	Place $100MM in account (seed money)	100	0	100	0	100		
2	IFM buys $100MM in securities	0	100	100	0	100		
3	Short sell $50MM of securities (generates $50MM in cash proceeds) - borrowed via a margin account	50	100	150	50	100	0	50%
4	IFM buys $50MM in securities	0	150	150	50	100	0	50%
5	To obtain the additional exposure required to execute strategy, IFM needs to enter into a derivative contract	0	150	150	50	100	50	100%

Result: Not treating cash and synthetic exposure the same (re leverage calc) results in additional operational burden and potentially higher fee structures

Appendix B – Re-hypothecation — Canadian Perspective

- Broker / Dealers in Canada regulated by IIROC

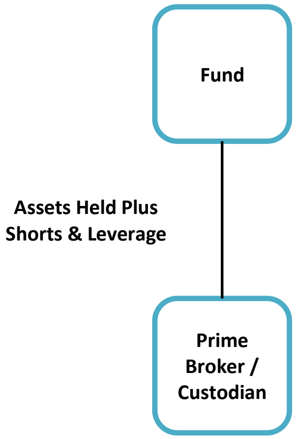
- IIROC members are required to:
    - provide quantitative disclosure on exposures and the amount of client assets held in segregation
    - issue month-end customer statements showing holdings of assets and amounts held in segregation
    - report “Client Net Equity” in their financial report filings
    - maintain up-to-date client segregation reports (securities) and client sub-ledger reports (customer balances)

- IIROC effectively prohibits dealers from using their clients’ assets for their own-account activities by:
    - requiring that all fully paid or excess margin securities be segregated and identified as being held in trust for each client
    - imposing a quantitative limit of 100% of a customer’s indebtedness to the dealer on the value of client securities that are available to the dealer for re-hypothecation
    - with respect to client cash, prescribing both a minimum reserve amount that must be held in segregation and a maximum amount available for use by the dealer in the conduct of its business
    - through the application of capital, liquidity, margin and net equity requirements

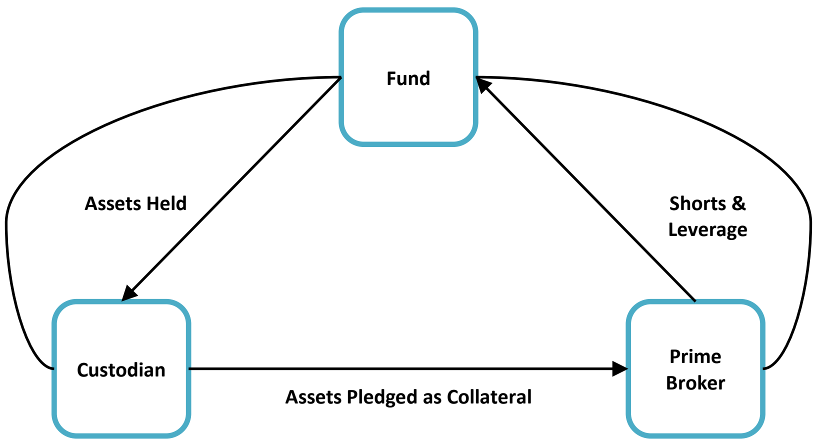
http://www.fsb.org/wp-content/uploads/Re-hypothecation-and-collateral-re-use.pdf

Appendix C – Financing Structures Available for Alternative Mutual Funds

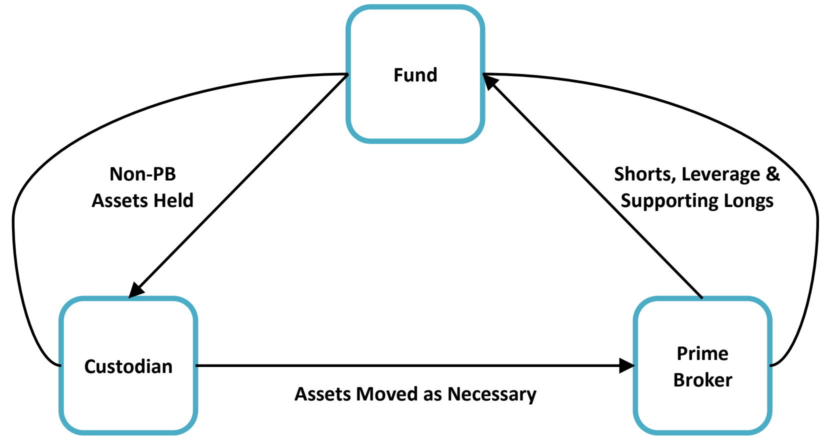
Structure 1: Prime Broker as Custodian



Structure 2: Tri-Party Pledge



Structure 3: Custody + Prime Brokerage



Structure 4: Sub-Custody