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SUBMITTED BY E-MAIL

British Columbia Securities Commission
Alberta Securities Commission
Saskatchewan Financial Services Commission
Manitoba Securities Commission
Ontario Securities Commission
Autorité des marchés financiers
New Brunswick Securities Commission
Registrar of Securities, Prince Edward Island
Nova Scotia Securities Commission
Superintendent of Securities, Newfoundland and Labrador
Superintendent of Securities, Northwest Territories
Superintendent of Securities, Yukon Territory
Superintendent of Securities, Nunavut
(collectively, the "**CSA**")

Dear Ladies and Gentlemen:

Re: CSA Staff Notice 81-322 (the "Notice") – Status Report on the Implementation of the Modernization of Investment Fund Product Regulation Project and Request for Comment on Phase 2 Proposals

Thank you for providing us with the opportunity to comment on the Notice.

About Faskens

Fasken Martineau DuMoulin LLP ("**Faskens**") is a leading Canadian law firm which provides advice to investment fund managers, dealers and service providers primarily through our offices in Toronto, Montréal, Vancouver, Calgary and Paris. Currently, twelve partners at Faskens devote a substantial portion of their practice to advising clients on structuring, offering and managing investment fund products and services, and are supported by further partners with expertise in specific fields including tax, derivatives and financial institution regulation. This positions Faskens as one of the largest Canadian legal practices in this field. Our client base includes managers of retail mutual funds, closed-end funds, exchange-traded funds, commodity pools, hedge funds, pooled funds, segregated funds, private equity funds and separately managed account services. We regularly assist clients with developing innovative investment products including, where necessary, obtaining novel discretionary relief under Canadian

securities legislation and advance tax rulings to accommodate those products. In providing our comments below, we have drawn from our experience assisting clients with developing and managing a wide range of conventional and innovative products and services that satisfy investor needs as well as address securities regulatory, tax and operational requirements.

Proposals in the Notice

The CSA are proposing the following additional regulations in the Notice:

- Extending the self-dealing requirements in Part 4 of National Instrument 81-102 *Mutual Funds* ("**NI 81-102**") and the related party investment restrictions from section 111 of the *Securities Act* (Ontario) (the "**OSA**") (and the equivalent securities legislation in certain other Canadian jurisdictions) to non-redeemable investment funds

- Introducing voting rights for investors in non-redeemable investment funds for fundamental changes to the fund (including changes to the fund's investment objective or fee structure, as well as a fund merger) and to the management of the fund (which, we assume, refers to changing the manager to a company not affiliated with the fund's current manager)

- Custodian requirements for the safeguarding of fund assets

- Minimum investment restrictions

The Notice states that these proposals reflect the CSA's efforts to "…regulate comparable publicly offered investment fund products in a similar manner…", and to "…reduce the potential for regulatory arbitrage that may exist within the current regulatory framework". In several instances, the Notice refers to these proposals as intended to ensure "…investor protection, fairness and market efficiency objectives…".

We suggest that non-redeemable investment funds already operate under securities regulations and industry standards that are more stringent than other investment options available to retail investors including (among others) direct investments in individual stocks and bonds, segregated funds (individual variable insurance contracts) and linked notes. For example, non-redeemable investment funds are governed by the conflict of interest regulations contained in National Instrument 81-107 *Independent Review Committee for Investment Funds* ("**NI 81-107**") and section 13.5 of National Instrument 31-103 *Registration Requirements, Exemptions and Ongoing Registrant Obligations* ("**NI 31-103**"). National Instrument 81-106 *Investment Fund Continuous Disclosure* ("**NI 81-106**") ensures that, among other matters, non-redeemable investment funds calculate and disclose their net asset values on a periodic basis to provide transparency relating to fund value and performance. As well, industry standards expect that investors

in non-redeemable investment funds will have voting rights relating to certain material changes to their funds. Equivalent regulations do not currently exist for other investment options. For this reason, by introducing new regulations for non-redeemable investment funds, the CSA may unintentionally exacerbate, rather than reduce, the potential for regulatory arbitrage. Accordingly, we encourage the CSA to consider new regulations for non-redeemable investment funds in the larger context of all investment options available to retail investors. In this way, any such new regulations can reduce the potential for regulatory arbitrage and create a more level playing field for the investment management industry.

Responses to Specific Issues for Comment:

1. *Do you agree with our view that certain consistent, core investor protection requirements should apply equally to all types of publicly offered investment funds? We particularly seek feedback from investors.*

We agree that certain core investor protection requirements should apply to all types of publicly offered investment funds. However, existing conflict of interest regulations are a patchwork of duplicative and sometimes conflicting requirements and prohibitions that were developed at different times, in different jurisdictions and for differing purposes. This has resulted in a compliance maze where a single transaction often must consider multiple conflict of interest regulations (and, on occasion, seek multiple discretionary exemptions) that, ultimately, are addressing the same issue. (An obvious example is the duplication between section 13.5(2) of NI 31-103 and Part 4 of NI 81-102.) Rather than extending this complexity to non-redeemable investment funds, we encourage the CSA to be selective and streamlined in their adoption of conflict of interest regulations for non-redeemable investment funds in an effort to rationalize the myriad of existing conflict of interest regulations. This would include codifying various exemptive relief that are routinely granted from these regulations.

2. *Do you agree with our approach to develop a standalone operational rule for non-redeemable investment funds? If not, what approach would you propose? What are the advantages and disadvantages of this approach?*

To the extent that the CSA decide to implement additional regulations for non-redeemable investment funds, we support the approach of a standalone operational rule to that effect. We believe that such an approach would benefit from the public consultation and transparency associated with the rule-making process and would simplify compliance by providing such regulation from a single source. Any such operation rule should supercede all existing positions expressed by CSA staff in notices or other publications (for example, OSC Staff Notice 81-711 *Closed-End Investment Fund Conversions to Open-End Mutual Funds*) unless included in the operational rule and therefore re-examined under the rule-making process.

3. *We seek feedback on the initial restrictions and operational requirements we have identified for non-redeemable investment funds. If you disagree, what restrictions and operational requirements would be appropriate for non-redeemable investment funds at this time? If you think no requirements are needed, please explain why.*

Conflict of Interest Matters

Investments by non-redeemable investment funds in related parties likely are subject to regulation as conflict of interest matters under NI 81-107. We support the extension of section 111(2)(a) of the OSA and the equivalent securities legislation in certain other Canadian jurisdictions to non-redeemable investment funds. This would make such investments subject to pre-approval by the fund's independent review committee (the "**IRC**") on the terms specified in section 6.2 of NI 81-107. We also support extending to non-redeemable investment funds the prohibition in section 111(2)(c) of the OSA (investing in an issuer in which a responsible person holds a significant interest) provided a related change is made to NI 81-107 to allow such investments to proceed with IRC approval.

We do not believe it is necessary to extend section 111(2)(b) of the OSA (the prohibition against investing in an issuer in which the fund, together with related mutual funds, is a substantial securityholder). This provision has been used in the past by the CSA as a source for regulating fund-on-fund investing and minimizing the extent to which a related group of funds may exert influence over an issuer. Principles for permitted fund-on-fund investing have been established in section 2.5 of NI 81-102 and, by current industry practice, are observed by many non-redeemable investment funds even though non-redeemable investment funds are not legally restricted from making such fund-on-fund investments. Non-redeemable investment funds are, by definition, prohibited from investing for the purpose of seeking to exercise control of an issuer. As well, Part 10 of NI 81-106 imposes on non-redeemable investment funds the same requirements concerning proxy voting policies and reporting as apply to public mutual funds.

Section 4.1(1) of NI 81-102 prohibits a public mutual fund from purchasing securities of an issuer within 60 days after that class of securities was distributed by a dealer related to the fund's manager. Various exemptions from the prohibition are available which, in most cases, require IRC approval. We support the extension of Section 4.1(1) of NI 81-102 to non-redeemable investment funds on the same basis, provided that the routine discretionary relief also is codified.

Section 4.1(2) of NI 81-102 prohibits a public mutual fund from making an investment in an issuer in which a responsible person of the public mutual fund is a partner, director or officer unless certain conditions are satisfied. The prohibition is effectively duplicated in

section 13.5(2)(a) of NI 31-103 and, for this reason, need not be extended to non-redeemable investment funds.

Section 4.2 of NI 81-102 prohibits a public mutual fund from trading securities with certain persons as principal. The prohibition is effectively duplicated in section 13.5(2)(b) of NI 31-103 and, for this reason, need not be extended to non-redeemable investment funds.

Custody of Fund Assets

As identified in the Notice, non-redeemable investment funds already are subject to the same custodial requirements as public mutual funds by reason of Part 14 of National Instrument 41-101 *General Prospectus Requirements* ("**NI 41-101**"). The change of law effected by the introduction of this requirement may have been overlooked by some industry participants who expected NI 41-101 to relate mainly to prospectus content rather than operational matters.

Part 14 has created an impediment for non-redeemable investment funds to the extent that their investment mandates require their assets to be deposited with a prime broker rather than a custodian. As well, current requirements that the custodian be a Canadian financial institution limit price competition between these service providers. We encourage the CSA to amend these requirements in order that non-redeemable investment funds may deposit assets with prime brokers in accordance with industry practice and may access a broader universe of available custodians.

Securityholder Voting Rights

We agree with the CSA's suggestion that investors in non-redeemable investment funds should be entitled to vote on certain fundamental changes to the fund. Current industry practice already provides such entitlements. In our view, these fundamental changes would include a change to the fund's fundamental investment objective or an increase in the management fee paid by the fund to its manager. However, we make such recommendation only if investment fund managers continue to have their current flexibility to articulate the non-redeemable investment fund's investment objective in the manner which the manager considers most suitable. Non-redeemable investment funds, by their nature, may seek outcomes for investors and measure the success of their mandate by means different than that contemplated by Instructions (1) and (3) to Form 81-101F1, Part B, Item 6. For greater certainty, we do not support any proposal that, as a corollary, would require the non-redeemable investment fund to include in its investment objective a description of the types of securities in which it intends to invest, or the key investment strategies it intends to utilize.

4. *Are there other investor protection principles and/or requirements of NI 81-102 which the CSA should consider for non-redeemable investment funds at this time? If so, please explain.*

For the reasons provided elsewhere in this letter, we do not believe it is necessary to apply other investor protection principles and/or requirements from NI 81-102 to non-redeemable investment funds.

5. *In addition to the initial requirements the CSA has identified for non-redeemable investment funds, we are considering the possibility of imposing certain investment restrictions, similar to those set out under Part 2 of NI 81-102. Please identify those core investment restrictions that, in your view, should apply to these funds and explain why. If you think no investment restrictions are needed, please explain why.*

We strongly disagree with the proposal to introduce investment restrictions for non-redeemable investment funds.

Non-redeemable investment funds provide investment fund managers, financial advisors and investors with an opportunity to access mandates and features not permitted in public mutual funds. These include alternative investment strategies which may provide investors with exposure to asset classes (such as commodities, real property, flow-through shares, distressed debt and offshore hedge funds) or techniques (such as single stock or other concentrated exposure, leverage, long/short strategies and long-term derivatives) not permitted in public mutual funds. Innovations in fund structures and investment approaches often first occur in non-redeemable investment funds. Investors who do not wish to access these alternatives and innovations can instead choose to invest in public mutual funds.

We anticipate that the investment restrictions for non-redeemable investment funds most likely to be proposed by the CSA would relate to a minimum level of liquidity and diversification in the investment portfolio of the non-redeemable investment fund. The reasons for requiring liquidity in public mutual funds include ensuring that the mutual fund is able to (a) calculate its net asset value per security for purposes of processing daily purchases and redemptions of its securities with minimal reliance on the fair valuation of illiquid assets, (b) access cash to honour daily redemption requests, and (c) readily modify its holdings to comply with various investment restrictions in NI 81-102. None of such requirements apply to non-redeemable investment funds. Investors in non-redeemable investment funds generally have access to daily liquidity by trading their securities over a stock exchange. Market participants receive sufficient information in the form of daily or weekly net asset value calculations and other continuous disclosure under NI 81-106 to be able to value the securities of non-redeemable investment funds for secondary trading purposes. (This information may, in fact, be more reliable for

purposes of valuing the securities of an investment fund than equivalent information disclosed by public companies.) Non-redeemable investment funds are not subject to the investment restrictions of NI 81-102.

The main reason for requiring diversification in the investment portfolios of public mutual funds is to mitigate investment risk and volatility. We do not believe that measures should be taken to mitigate investment risk and volatility in non-redeemable investment funds since the purpose of such funds is to provide investment alternatives to public mutual funds. Any material features of the investment performance expected from a particular investment mandate (including investment risks and volatility) can be addressed through prospectus disclosure.

In our view, any consideration by the CSA of investment restrictions for non-redeemable investment funds also must include a consideration of the role of the financial advisor and his or her sponsoring firm in advising investors about non-redeemable investment funds. Subject to very few exceptions, non-redeemable investment funds can be purchased and sold only through full-service dealers that are members of the Investment Industry Regulatory Organization of Canada ("**IIROC**"). These firms and their dealing representatives must satisfy higher proficiency and other requirements than those applicable to mutual fund dealers in Canada. Financial advisors at IIROC firms therefore are qualified to understand the features of each non-redeemable investment fund and recommend it to a client only in circumstances where the fund is a suitable investment for the client. The introduction of investment restrictions would suggest that the CSA lack confidence in the ability of such financial advisors to fulfill such role which, if true, identifies an issue with training and supervision that is not unique to non-redeemable investment funds.

6. *What do you foresee as the anticipated cost burdens in complying with the initial restrictions and operational requirements we are proposing for non-redeemable investment funds? Specifically, we request data from the investment fund industry and service providers on the anticipated costs of complying with the Phase 2 proposals.*

We defer to industry participants on the anticipated cost burdens of the additional regulations proposed in the Notice. However, we suspect that such costs will be incremental since public non-redeemable investment funds already are subject to the same requirements as public mutual funds under NI 81-106 and NI 81-107. In our view, the principal cost will be non-monetary: additional regulations will hinder the ability of investors to access Canadian-based investment fund alternatives to public mutual funds.

We trust that the foregoing comments will be of assistance to the CSA. We would be pleased to elaborate upon our comments at your request.

Yours very truly,

Fasken Martineau DuMoulin LLP