TREZ CAPITAL

June 20, 2013

British Columbia Securities Commission
Alberta Securities Commission
Financial and Consumer Affairs Authority of Saskatchewan
Manitoba Securities Commission
Ontario Securities Commission
Autorité des marchés financiers
New Brunswick Securities Commission
Superintendent of Securities, Department of Justice and Public Safety, Prince Edward Island
Nova Scotia Securities Commission
Securities Commission of Newfoundland and Labrador
Superintendent of Securities, Northwest Territories
Superintendent of Securities, Yukon
Superintendent of Securities, Nunavut
(the "**CSA**")

Re: **Modernization of Investment Fund Product Regulation (Phase 2): Canadian Securities Administrators Notice and Request for Comment on Proposed Amendments to National Instrument 81-102 *Mutual Funds*, Companion Policy 81-102CP *Mutual Funds* and Related Consequential Amendments and Other Matters Concerning National Instrument 81-104 *Commodity Pools* and Securities Lending, Repurchases and Reverse Repurchases by Investment Funds** (the "**Proposed Amendments**")

BACKGROUND

Thank you for inviting comments on the Proposed Amendments which, if implemented as drafted, would significantly and adversely affect Canadian retail investors in our investment funds as well as the segment of the Canadian capital markets that relies upon us as a source of financing. Accordingly, we request that you consider our comments set out below.

Who we are

Trez Capital Fund Management Limited Partnership (the "**Manager**") is the manager of several public investment funds which currently invest in mortgages, including Trez Capital Mortgage Investment Corporation and Trez Capital Senior Mortgage Investment Corporation (the "**Trez MICs**"). Each Trez MIC is a non-redeemable investment fund, the securities of which are listed for trading on the Toronto Stock Exchange (the "**TSX**"). The Manager is registered as an investment fund manager under the securities laws of British Columbia and elsewhere, and as a portfolio manager (restricted to mortgage investments) under the securities laws of British Columbia.

Trez Capital Limited Partnership (the "**Mortgage Broker**" and, together with the Manager, "**Trez**", or "**we**") is a licensed mortgage broker under the *Mortgage Brokers Act* (British

Columbia) and equivalent legislation in the other provinces of Canada. The Mortgage Broker is related to the Manager in that both the Manager and the Mortgage Broker are wholly-owned by Trez Capital Group Limited Partnership.

Trez is a mortgage brokerage and investment management company that employs a conservative and risk-averse approach to real estate-based investments. Trez and its predecessors have been in operation over 15 years and, during that time, have made more than 800 mortgage investments in Canada totalling over $3 billion. We currently are one of the largest alternative lenders of short-term bridge mortgages in Canada with approximately $1.5 billion in fee-earning assets of which approximately $1.1 billion is currently invested in mortgages.

What we do

Trez provides essential financing to established real estate developers and owners who require short-term bridge financing until they are able to replace their mortgages with lower cost financing from traditional lenders (such as banks and trust companies). Each mortgage investment made by Trez usually has a term to maturity of not more than 36 months (and usually under 24 months) and is secured by real property in Canada with a loan-to-value generally not exceeding 85%. These mortgage investments are <u>not</u> sub-prime. Trez operates within a niche market that is under-serviced due to traditional financial institutions generally not dedicating sufficient resources to originate and approve these mortgages investments on a timely and flexible basis. Consequently, borrowers are willing to pay higher interest rates for such short-term mortgages because they provide the borrowers with (a) the ability to execute quickly on real estate investment opportunities, (b) loan terms that are in-line with their business model, and (c) potentially lower monthly payments through interest-only payments until the maturity of the mortgage. As a result of this under-servicing, Trez is able to obtain very favourable risk-adjusted rates of return for the investors in its funds. Since Trez commenced operations in 1997, only 3 out of more than 800 mortgage investments it has made in Canada have not been repaid in full.

Prior to being approved, each mortgage investment by Trez is subject to a rigorous due diligence process which Trez has developed over 15 years of experience. Mortgage investments, once made by investment funds managed by Trez, are not liquid investments in that they cannot readily be sold to a third party over an open exchange (though it is theoretically possible – but not commercially practical – to sell mortgage investments to other entities through private transactions). Instead, each Trez fund holds each of its mortgage investments until maturity. During the term of each mortgage investment, the Trez fund receives monthly interest payments from the borrower.

As described above, Trez's past record of making mortgage investments only with sound borrowers who repay their mortgages in full is excellent. Accordingly, though the assets of each Trez fund are illiquid, they nonetheless are sound investments for investors. Few investment fund managers are able to provide investors with the risk-adjusted rates of returns provided by investment funds managed by Trez.

COMMENTS ON PROPOSED AMENDMENTS

Policy overview

Rationale underlying the Proposed Amendments

The Proposed Amendments represent a significant departure from the current regulation of non-redeemable investment funds. Recently, when the CSA have introduced other significant proposed regulations for the investment funds industry, they have been preceded by a thoughtful analysis of the underlying policy considerations for the proposals. We cite, as examples, the CSA Discussion Paper and Request for Comment 81-407 *Mutual Fund Fees* and the CSA Consultation Paper 33-403 *The Standard of Conduct for Advisers and Dealers*. The Proposed Amendments would have an impact on the capital markets and investment options available to Canadians that is at least as significant as the two examples cited above, yet the Proposed Amendments are not supported by an equivalent analysis of the role and function of non-redeemable investment funds.

Historically, it has been accepted by the CSA that non-redeemable investment funds are the avenue for creating investment products for investors outside the investment restrictions of public mutual funds. We note that it has been the express position of the CSA that managers wishing to sell to the public investment funds which do not comply with the investment restrictions contained in National Instrument 81-102 *Mutual Funds* ("**NI 81-102**") and National Instrument 81-104 *Commodity Pools* should structure their products as non-redeemable investment funds or distribute securities on a prospectus-exempt basis[1]. The Proposed Amendments offer no meaningful explanation why the CSA propose to change their current view on the role of non-redeemable investment funds as an alternative to public mutual funds.

Instead, the Notice suggests that possible reasons for the Proposed Amendments include the following:

- to establish parameters for investment funds to meet the expectations of retail investors who invest in pooled investment products,
- to prohibit activities that are inconsistent with the fundamental characteristics of investment funds as passive investment vehicles,
- to reflect prudent fund management practices, and
- to create a more consistent framework within which public mutual funds, exchange-traded funds and non-redeemable investment funds can compete with each other.

With respect, we submit that each of these suggested reasons for the Proposed Amendments is flawed.

Expectations of retail investors: There is no evidence cited by the CSA to suggest that retail investors in non-redeemable investment funds expect such funds to follow investment

[1] See Section 1.2(2) of Companion Policy 81-104.

restrictions comparable to public mutual funds. We suggest that the opposite is true: by receiving a long-form prospectus and purchasing securities which trade on a stock exchange, retail investors understand and expect that non-redeemable investment funds may differ materially from public mutual funds.

Passive investment vehicles: The CSA have taken the liberty of interpreting the definition of "non-redeemable investment fund" to mean that an investment fund cannot be actively involved in negotiating the terms of its investments. We disagree with that interpretation. A non-redeemable investment fund means an issuer which (among other matters) does not invest (i) for the purpose of exercising or seeking to exercise control of an issuer, or (ii) for the purpose of being actively involved in the management of any issuer in which it invests[2]. These requirements do not preclude a non-redeemable investment fund, through its manager, from negotiating the terms of the fund's investment in an issuer since such negotiations, by themselves, do not constitute an attempt by the investment fund to exercise control over the issuer nor to become actively involved in the issuer's management.

Prudent fund management: While it is correct that non-redeemable investment funds often contain features which are not found in public mutual funds, there is no evidence cited by the CSA to support a conclusion that those differing features are flawed. Rather than rely on the proposition that non-redeemable investment funds should become more standardized with public mutual funds, the CSA should cite specific instances where current features in non-redeemable investment funds have been prejudicial to investors.

Competition between investment fund products: Differently structured investment fund products currently compete with each other based on the differences they are able to provide to investors. For example, exchange-traded investment funds have tended to track indices with no dealer compensation being paid by the fund's manager. As a result, exchange-traded funds have been competing with public mutual funds based mainly on lower management expense ratios and the ability to "day trade" the fund. Non-redeemable investment funds similarly provide investors with structural alternatives to public mutual funds which, if standardized with public mutual funds, will reduce, rather than increase, competition and innovation between investment fund products.

Role of registered brokers and dealers

Since every non-redeemable investment fund is, by definition, not a "mutual fund" under Canadian securities laws, the securities of non-redeemable investment funds can be sold to investors only by full-service registered dealers and their individual brokers[3]. These full service dealers and brokers are subject to higher proficiency requirements than their mutual fund dealer counterparts in order to ensure that they are able to understand and recommend to their clients only those investments which are suitable for them. This proficiency covers the widest possible range of investment options available in Canada including stocks and bonds of public companies, as well as structured products and non-redeemable investment funds.

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[2] See paragraph (b) in the definition of "non-redeemable investment fund" contained in Section 1(1) of the *Securities Act* (British Columbia) and equivalent securities legislation in other Canadian jurisdictions.

[3] An "investment dealer" and its "dealing representatives" as defined in National Instrument 31-103 *Registration Requirements, Exemptions and Ongoing Registrant Obligations.*

The Proposed Amendments do not discuss the role played by full service dealers and brokers on behalf of their clients when selecting an investment in a non-redeemable investment fund. We believe this is a glaring oversight in the Proposed Amendments. Each public offering by a non-redeemable investment fund is subject to rigorous due diligence and internal approvals by the full service dealers in its selling agent group. The marketing of these public offerings typically includes in-person "roadshow" meetings with individual brokers where brokers are further informed of the features of each non-redeemable investment fund, are provided with the opportunity to ask questions and seek clarifications, and are supported by a summary "greensheet" document highlighting the most important features of the public offering. Assuming that the individual brokers "know-their-client" and "know-their-product", each broker recommends a non-redeemable investment fund to their client only if it is suitable for that client.

By proposing limits on the features of non-redeemable investment funds, the Proposed Amendments are suggesting that full service dealers and their brokers are not fulfilling their statutory duties when recommending non-redeemable investment funds to their clients. The CSA provide no evidence on which to base such an assertion. The CSA also provide no policy rationale for imposing restrictions on non-redeemable investment funds while no equivalent restrictions exist for purchasing stocks and bonds of public companies.

In our view, if the CSA have concerns that some investors may not adequately understand the features of some non-redeemable investment funds or may be purchasing some non-redeemable investment funds which are not suitable for them, the flaw lies in the relationship between the investor and his or her broker, rather than in the investment itself.

Accordingly, before proceeding further with the Proposed Amendments, we believe it is incumbent upon the CSA to explain why the CSA are of the view that (i) the role currently played by full service dealers and their brokers is inadequate, and (ii) the CSA's concerns cannot be addressed through further regulation of the broker-client relationship.

Cost-benefit analysis

The CSA state in the Proposed Amendments that the Proposed Amendments will not create substantial costs for investment funds, their managers or securityholders. We disagree. The costs for managers associated with the Proposed Amendments will be significant. For example, the proposal to shift organizational costs from the investment fund to its manager may create a sufficiently large barrier that many managers of non-redeemable investment funds will no longer be able to offer new funds to investors. Where the manager is able to finance such costs, they will be recouped from the investment fund through higher management fees. As a result, securityholders of non-redeemable investment funds will continue to bear the organizational costs, but in the form of higher management fees and redemption fees. These organizational costs likely will be greater than if paid directly by the investment fund out of its closing proceeds since the cost of financing these expenses (e.g. interest) also will be passed through to the investment fund in the form of higher fees.

No quantitative analysis of this shift of expenses is provided in the Proposed Amendments. Instead, the CSA have merely stated that "...we think the potential benefits of the Proposed Amendments are proportionate to their costs". In our view, this does not constitute a meaningful analysis of the relative costs and benefits of the Proposed Amendments. Instead, it has shifted

the burden onto the investment funds industry to perform the cost-benefit analysis on behalf of the CSA.

Investment in mortgages

The Proposed Amendments would prohibit publicly offered non-redeemable investment funds from investing in any mortgage that is not fully and unconditionally guaranteed by a government or government agency ("**non-guaranteed mortgages**").

Each Trez MIC invest exclusively in non-guaranteed mortgages. Each such mortgage investment is unique and individually negotiated with each borrower to provide bridge financing until the borrower is able to advance their real estate project to a stage where replacement financing can be obtained from a conventional source. If enacted, this proposed prohibition would render it impossible for the Trez MICs to pursue their investment mandates and would eliminate a vital source of financing real estate investors and developers.

The Proposed Amendments state that the CSA are of the view that non-guaranteed mortgages "...may not be appropriate investments for publicly offered investment funds" but provide no explanation of the basis for reaching that conclusion. Though the Proposed Amendments contain a cross-reference to CSA Staff Notice 31-323 *Guidance Related to the Registration Obligations of Mortgage Investment Entities* ("**Notice 31-323**"), there is no discussion in Notice 31-323 of any policy concerns of the CSA with permitting publicly offered investment funds to invest in non-guaranteed mortgages. (We also would point out that Notice 31-323 does not have the force of law and was not subject to any formal public consultation process.)

We speculate that there may be two possible sources of concern of the CSA regarding investments by non-redeemable investment funds in non-guaranteed mortgages, namely (a) the ability to fund redemptions given the illiquid nature of mortgage investments, and (b) the ability to accurately value mortgage investments. We disagree with both of those possible concerns.

Liquidity to fund redemptions: One of the principal reasons for structuring an investment fund as a non-redeemable investment fund is to provide investors with liquidity through a means other than redemptions, namely a stock exchange listing. With this in mind, each Trez MIC has carefully structured its redemption rights to ensure that they are limited by the amount of available cash which each Trez MIC expects to have in the ordinary course. For this reason, each Trez MIC limits annual redemptions to 15% of its outstanding shares, and provides for lengthy notice and payment time periods to enable the Trez MIC to retain cash for funding redemptions. Consequently, the illiquid nature of the investments of each Trez MIC does not conflict with the redemption rights of its securityholders. We emphasize that such securityholders always have liquidity through the ability to resell their securities of a Trez MIC over the TSX on any trading day.

Accuracy of valuation: During the past 15 years, Trez has experienced very few circumstances in which it has been unable to value any of its mortgage investments. Each mortgage investment is valued under Canadian generally accepted account principles ("**Canadian GAAP**"), including Accounting Guideline 18. Mortgage investments generally are valued by applying a discount rate to the future stream of payments expected to be received under the mortgage investment until its maturity. The discount rate is comprised of two components, namely the risk free rate of

interest for an equivalent term (determined by reference to the current yield of a Government of Canada bond with a term to maturity of the particular mortgage) and the issuer-specific risk which is determined at the time the mortgage investment is made. The fair value of each mortgage investment changes as the discount rate changes. However, issuer-specific risk tends not to change materially since each mortgage investment is relatively short term in nature and adequately secured by a charge on real property. Consequently, each mortgage investment can be valued relatively easily based mainly on changes to the risk-free rate of interest during the term of the mortgage investment (upward in the case of a decline in the risk-free rate, and vice versa).

In the absence of an articulated policy concern from the CSA, we are unable to respond further to the CSA's proposal to prohibit non-redeemable investment funds such as the Trez MICs from investing in non-guaranteed mortgages. Accordingly, before proceeding with this change, we believe that the CSA should articulate their concerns and provide the public with an opportunity to comment on those concerns.

Illiquid assets

The Proposed Amendments would limit the percentage of assets of a non-redeemable investment that could be invested in illiquid assets. As described above, each Trez MIC invests all of its assets in mortgages, each of which is considered illiquid. As also described above, we believe that no policy concerns arise from each Trez MIC holding a portfolio of illiquid investments since (a) redemption rights are structured to be commensurate with the available cash of the Trez MIC, (b) investors have liquidity through the ability to sell their securities over the TSX on any trading day, and (c) Trez is able to value each mortgage investment under Canadian GAAP.

Proposed transition to an alternate regulatory regime

The Proposed Amendments include a 24 month transition period during which a non-redeemable investment fund could divest its investments in non-guaranteed mortgages and seek approval from its investors to change its investment mandate. Such a transition is not possible for the Trez MICs since the only types of mortgage investments made by the Trez MICs is in non-guaranteed mortgages. These investments cannot be replaced with guaranteed mortgages.

The Proposed Amendments further suggest that non-redeemable investment funds may transition into the regulatory regime for issuers that are not investment funds as a means of continuing to invest in non-guaranteed mortgages. We refer herein to such issuers as "**mortgage investment issuers**". The CSA's suggestion fails to consider and address other negative regulatory impacts on these non-redeemable investment funds that would be triggered by such a transition including the following:

- Currently, some mortgage investment funds raise capital throughout the year under a continuous, prospectus-qualified distribution. However, section 8.2(1) of National Instrument 41-101 *General Prospectus Requirements* would effectively prohibit a continuous offering by a mortgage investment issuer since the distribution must be completed within 90 days following the receipt for the issuer's final prospectus.

- Where an issuer is not an investment fund, the CSA generally have prohibited so-called "blind pool" offerings where the use of proceeds from the distribution are not expressly defined. While a mortgage investment issuer is capable of disclosing its intent to spend the proceeds from its public distribution on investments in mortgages, it generally is unable to identify in its prospectus the specific mortgage investments that will occur.

In order for the CSA's suggestion of transition to an alternative regulatory regime to be meaningful, the CSA should address the negative regulatory impact associated with such a transition and provide solutions to those impediments. Otherwise, the effect of the Proposed Amendments will be to prohibit these funds from being able to raise additional capital in the future. For example, we believe the Proposed Amendments should include the following features:

- A change to existing securities legislation to permit a mortgage investment issuer to remain in continuous distribution.

- Confirmation that the CSA will not raise "blind pool" concerns regarding the prospectus of a mortgage investment issuer provided the prospectus describes the issuer's investment approach and confirms that any net proceeds from the offering not allocated to a specific use will be invested in accordance with that investment approach.

Borrowing

The Proposed Amendments would limit the amount which may be borrowed by a non-redeemable investment fund to an amount not greater than 30% of its net asset value. The only explanation provided by the CSA for this proposed limit is that it is consistent with the current limits voluntarily followed by the majority of non-redeemable investment funds. The proposal contains no explanation of the policy rationale for proposing such a limit.

We suggest that merely because a majority of non-redeemable investment fund currently do not borrow beyond 30% of their net asset value does not, by itself, provide a policy rationale for imposing such limit on all non-redeemable investment funds.

For your information, Trez Capital Senior Mortgage Investment Corporation currently is permitted to borrow an amount up to 40% of its total assets, which is equivalent to 67% of its net asset value. This borrowing is done for a number of reasons which are advantageous to investors in the Trez Capital Senior Mortgage Investment Corporation including to:

- manage its cash flow requirements

- manage timing differences between when existing mortgage investments are expected to be repaid and new mortgage investments are expected to be made, thereby enabling the Trez Capital Senior Mortgage Investment Corporation to remain fully invested at all times

- leverage the returns from the mortgage investments of the Trez Capital Senior Mortgage Investment Corporation by the difference between its cost of borrowing and the return it is able to receive from mortgage investments made with such borrowed funds.

The leverage associated with Trez Capital Senior Mortgage Investment Corporation is prudently managed and accretive to its yield. Since Trez knows both (a) the prevailing interest rate charged to Trez Capital Senior Mortgage Investment Corporation for amounts borrowed under its credit facility, and (b) the amount of interest income to be generated from the mortgage investment made using such borrowed cash, Trez can ensure that leverage will be used only to increase the returns of the Trez Capital Senior Mortgage Investment Corporation rather than risk a reduction of its returns. This differs materially from leverage utilized by other non-redeemable investment funds which purchase stocks and bonds in the open market with no guarantee that the returns from such investments will exceed the cost of borrowing to make such investments.

Incentive fees

We disagree with the suggestion in the Proposed Amendments that performance fees payable by non-redeemable investment funds should be structured in the same manner as for public mutual funds. While the regime set out in section 7.1 of NI 81-102 provides one example of a reasonable performance fee calculation, other reasonable performance fee structures also exist, many of which are more suitable to a non-redeemable investment fund than what is provided in section 7.1 of NI 81-102.

For example, many non-redeemable investment funds seek to provide their securityholders with a targeted rate of annual distributions supportable by the annual returns of the fund. These investments are viewed by investors as similar to fixed income and investors are expecting their fund's performance to match a pre-determined rate of return (known as a "**hurdle rate**"). From an investor's perspective, the manager has outperformed expectations to the extent it is able to generate returns in excess of those hurdle rates, rather than by reference to the performance of an index. We understand that the CSA interprets the phrase "benchmark or index" in section 7.1 of NI 81-102 as only including an index, and thereby precluding an annual hurdle rate of return. If the CSA proceeds with this proposed change, we believe that it would be contrary to the expectations of investors who instead are seeking annual returns in excess of a pre-determined hurdle rate.

Organizational costs

As discussed above, we believe that shifting organizational costs for non-redeemable investment funds to the manager will not result in a cost savings for investors as these costs will continue to be borne by the fund through higher management fees and the introduction of redemption fees. We also believe it is possible that the aggregate cost to the fund actually will increase since the manager's cost of financing the organizational costs will be added to the management fee and borne by the fund.

We disagree with the assertion of the CSA that shifting this cost to the manager will create new incentives to reduce these costs. Managers already seek to minimize these costs since they are at

risk for some or all of these expenses in the event that the public offering by the non-redeemable investment fund is not as successful as hoped.

We also point out that the primary policy reason for section 3.3 of NI 81-102 is to prevent a mutual fund from bearing its start-up costs which could represent a significant portion of its net asset value during the start-up phase. No such concern exists in the context of non-redeemable investment funds since the minimum sizes of their public offerings are sufficiently large to bear these expenses.

Further, the CSA should note that a majority of the start-up costs incurred by a non-redeemable investment fund is in the form of commissions paid to selling agents (typically approximately 5.25% of the gross proceeds of the offering) rather than the fund's organization costs which typically are limited to 1.5% of the gross proceeds of the offering. Consequently, the CSA's proposal will not reduce the largest expense incurred by a non-redeemable investment fund during its start-up stage since section 3.3 of NI 81-102 makes no reference to the costs associated with paying compensation to registered dealers. If the CSA propose to introduce such a prohibition on non-redeemable investment funds, this intention should be expressly stated, supported by an explanation of the policy rationale underlying such a change, and subject to further public comment.

NEXT STEPS

We understand that several other commentators have written to the CSA to request (among other matters) additional consultation in order that the CSA's policy rationale for the Proposed Amendments can be better understood. We agree with the position of those other commentators and likewise request that the CSA elaborate upon the policy considerations for the Proposed Amendments before proceeding further.

Our comments above may change depending upon the additional information which may be provided by the CSA in the future concerning the Proposed Amendments.

Yours truly,

TREZ CAPITAL FUND MANAGEMENT LIMITED PARTNERSHIP
by its general partner, Trez Capital Fund Management (2011) Corporation

Alexander (Sandy) Manson
Director and Chief Financial Officer