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August 23, 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
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
Superintendent of Securities, Nunavut

Attention:

The Secretary
Ontario Securities Commission
20 Queen Street West
19th Floor, Box 55
Toronto, ON M5H 3S8

Me Anne-Marie Beaudoin
Corporate Secretary
Autorité des marchés financiers
800, square Victoria, 22e étage
C.P. 246, Tour de la Bourse
Montréal (Quebec) H4Z 1G3

Re: CSA Notice and Request for Comment: Proposed Amendments to National Instrument 81-102 - *Mutual Funds* ("NI 81-102"), Companion Policy 81-102CP - *Mutual Funds* and Related Consequential Amendments and Other Matters Concerning National Instrument 81-104 - *Commodity Pools* ("NI 81-104") and Securities Lending, Repurchases and Reverse Repurchases by Investment Funds (collectively, the "Proposals")

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, London and Paris. Currently, eleven 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, trusts and financial institution regulation. Accordingly, Faskens is one of the largest Canadian legal practices in the investment products and wealth management area. Our client base includes managers of retail mutual funds, closed-end funds, exchange-traded funds, mortgage investment corporations, 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 structuring, offering and managing non-redeemable investment funds ("**NRIFs**").

Consultation Process

We have several concerns regarding the sufficiency of the information provided by the Canadian Securities Administrators (the "**CSA**") regarding the Proposals, which are articulated below. As a result, we believe it would be inappropriate for the CSA to proceed with the Proposals until it has provided an opportunity for public consultation on the additional matters described below.

Lack of a Policy Rationale

We are concerned by the lack of an explanation of a policy rationale for the Proposals. The CSA have stated that the goals of the Proposals are to seek fairness and level the playing field as between mutual funds and NRIFs, but have not provided information to support whether there is any harm to investors resulting from the current differences between mutual funds and NRIFs. Instead, the Proposals merely seek to standardize the regulation of NRIFs with mutual funds without taking into account the different classes of investors and advisors who utilize NRIFs.

As acknowledged by the CSA in the Proposals, NRIFs differ from mutual funds in certain key respects, including their respective methods of formation, distribution and liquidity/redemption rights. We note that these key differences have evolved over the past 15 years and did so largely as a result of the CSA's decision to permit a regime for investment funds that would otherwise be seeking exemptive relief from NI 81-102 and/or NI 81-104. We believe this evolution has been positive as it has resulted in a greater variety of investment options being available to investors and, more generally, a diverse and innovative investment funds industry.

We disagree that a policy based on fairness necessitates standardizing all types of investments funds under a common regulatory regime since this would reduce the choices available to investors including with respect to investment mandate, cost structure and liquidity. The Proposals could, for example, eliminate the ability of investors to have access to certain unique fund structures (such as flow-through limited partnerships and mortgage investment corporations), asset classes and portfolio management techniques but do not explain why this would be beneficial for investors.

FASKEN MARTINEAU

The availability of a diverse range of investment options is beneficial for investors. Accordingly, we suggest that the CSA articulate its policy rationale for the Proposals in order to enable meaningful public consultation of the Proposals which otherwise propose reductions to the choices available to investors.

Interconnection with the Alternative Funds Regime

The impact of the Proposals - particularly those relating to investment restrictions - are interconnected with the CSA's proposed amendments to NI 81-104 (the "**Alternative Funds Regime**"), which have not yet been fully articulated. While it may be valuable for the CSA to seek and consider comments based on the Proposals as currently drafted, it is not possible to provide complete and meaningful comments on the Proposals without understanding what will be permitted under the Alternative Funds Regime. Accordingly, we believe that the Proposals should be republished with a complete explanation of the Alternative Funds Regime in order that the merits and interplay of both regimes can be subject to public consultation.

Absence of a Meaningful Description of Anticipated Costs and Benefits

Notwithstanding the requirements in section 143.2(2)7 of the *Securities Act* (Ontario) and equivalent requirements in the securities legislation of other Canadian jurisdictions, the Proposals do not describe their anticipated costs and benefits. The Proposals only state a number of assumptions and conclusions of the CSA regarding the anticipated costs of benefits without detailing or quantifying those costs and benefits. There is, for example, no information provided by the CSA to justify its statement that:

> "Overall, we think the potential benefits of the Proposed Amendments are proportionate to their costs."

Instead, the Proposals have reversed the onus of the cost/benefit considerations by inviting commentators to provide specific quantitative data in support of a view which disagrees with that of the CSA. In our view, this "reverse onus" does not fulfill the requirements of Canadian securities legislation for the CSA to provide a meaningful description of the anticipated costs and benefits of the Proposals. For this reason, we believe that the CSA should provide a more detailed description of the costs and benefits of the Proposals for public consultation before proceeding further.

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Investment Restrictions

Leverage

We are concerned by the CSA's proposal to limit the use of leverage by an NRIF to 30% of its net asset value ("**NAV**") for a number of reasons.

First, 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 NRIFs. The Proposals contain no explanation of the policy rationale for making such a limit mandatory for all NRIFs. In our view, merely because a majority of NRIFs currently do not employ leverage beyond 30% of their net asset value does not, by itself, provide a policy rationale for imposing such a limit on all NRIFs.

Second, Form 41-101F2, Item 3, section 3.3(1)(e) currently utilizes an overly simplistic description of the leverage ratio as: (a) total long positions and total short positions, divided by (b) net assets. This description assumes that all long and short positions add market exposure to an investment portfolio, thereby potentially increasing volatility. The description fails to acknowledge that long and short positions also may held for hedging purposes which thereby reduces (rather than increases) market exposure and volatility. Some NRIFs attempt to explain this defect in the disclosure required by Form 41-101F2. Before proceeding with a proposed limit on leverage, the CSA should articulate a new definition of "leverage" which takes into account that market exposure is reduced by positions held as hedges.

The Proposals also suggest that leverage is an inherently negative trait from the perspective of investors. While leverage can increase risk, it also can enhance returns where the cost of leverage is exceeded by the returns generated from the additional investments. As well, leverage can be used for hedging purposes which reduces volatility and risk. We therefore suggest that the Proposals focus on enhancing the disclosure relating to the anticipated effects of leverage on each NRIF, rather than imposing a blanket limit for each NRIF.

The CSA also propose that NRIFs be permitted to borrow only from lenders that are "Canadian financial institutions" (as defined in National Instrument 14-101 - *Definitions*). The justification for this proposal appears to be the expectation that the lender will perform a compliance function for ensuring that the NRIF's borrowing complies with its investment strategies and, presumably, the proposed leverage limit. We disagree that it is the role of the lender to monitor compliance by the NRIF with its investment restrictions. In fact, the opposite typically is the case: the lender relies upon representations for the NRIF concerning compliance with investment restrictions rather than independently verifying such compliance. Further, there is no reason to believe that only Canadian financial institutions could fulfill the role desired by the CSA. In our view, this proposal would create a limitation on the range of possible lenders available to NRIFs - some of which may provide more attractive lending terms - with no basis for such a limitation.

The Proposals also suggest that any NRIF which employs leverage beyond the prescribed limit would be governed by the Alternative Funds Regime. Without providing a fully-articulated Alternative Funds Regime, it is not possible for us to determine whether the proposed leverage limit would be appropriate for NRIFs not governed by the Alternative Funds Regime. For example, if the Alternative Funds Regime were to impose significantly greater costs, regulatory burdens or other impediments, then it will be necessary for most NRIFs to continue outside the Alternative Funds Regime, in which even a leverage limit greater than 30% may be needed.

Concentration Restriction

The main function performed by the 10% concentration limit in NI 81-102 is to effectively require that public mutual funds maintain diversified investment portfolios which potentially reduces the volatility of their performance. We are not aware of a policy reason for extending this requirement to NRIFs. Investment funds which invest in a relatively small number of issuers typically disclose, as a risk factor, that their returns may be more volatile than if the fund maintained a more diversified portfolio. In our view, this disclosure, together with the advice received by the investor from his or her advisor regarding the suitability of the investment, adequately addresses any concerns regarding NRIFs which maintain concentrated portfolios.

Further, while the proposed concentration restriction may be consistent with the current investment restrictions of a majority of NRIFs, many existing NRIFs are permitted to hold securities of a small number of issuers including, in some cases, only a single issuer. These NRIFs would no longer be permitted under the Proposals and instead would be governed by the Alternative Funds Regime. Without seeing a fully-articulated Alternative Funds Regime, we are unable to comment whether the proposed concentration limit is appropriate for NRIFs, if implemented.

For the reasons cited above, we do not believe it is appropriate to introduce a 10% concentration limit for NRIFs at this time.

Investments in Illiquid Securities

The summary to the Proposals suggests that the limitation on holding illiquid securities would be higher for NRIFs than public mutual funds. However, the changes contained in

FASKEN MARTINEAU

the Proposals themselves would establish the same 10% limit for NRIFs as for public mutual funds. Please clarify the intention of the CSA in this regard.

The main function performed by the 10% illiquid limit in NI 81-102 is to ensure that public mutual funds are able to quickly convert a sufficient portion of their assets to cash in order to fund redemptions in the ordinary course. Since public mutual funds typically permit redemptions daily, the requirement for liquidity is high. However, the same is not true for NRIFs. Generally, NRIFs permit redemptions based on net asset value only once annually. Investors also must provide lengthy notice of their intention to redeem, and the NRIF is given a lengthy period to pay the redemption proceeds. Some NRIF's also offer monthly redemptions at a discount to the current trading price of the security on a stock exchange (also coupled with lengthy notice and payment provisions), but these monthly redemption rights are exercised infrequently. The result of the above is that NRIFs usually have sufficient time and liquidity in their investment portfolios to honour all redemptions, despite possibly holding a significant amount of illiquid investments. Where the investment mandate of a NRIF contemplates a significant amount of illiquid assets, the redemption rights are either capped or not offered at all. Accordingly, NRIFs have been structured to match redemption rights with the expected liquidity of the NRIF's assets.

We see no advantage to investors from introducing a 10% illiquidity limit for NRIFs. Investors in NRIFs are offered liquidity to exit their investment by selling their securities over a stock exchange (if listed). In our view, the proposed new requirement will only limit the range of investment options available to investors by limiting or prohibiting investments in asset classes such as public-private infrastructure partnerships, venture capital opportunities, mortgages and other investments that could benefit investors. The illiquid limit would effectively eliminate certain classes of NRIFs such as mortgage investment entities (which invest in mortgages) and flow-through limited partnerships (which often invest mainly in unlisted securities of junior exploration companies). We believe that such NRIFs should be fully exempt from any illiquidity limits which may be implemented.

As with the proposed leverage limit and concentration restriction discussed above, any NRIF that exceeded the proposed illiquidity limit would be subject to the Alternative Funds Regime. Without seeing a fully-articulated Alternative Funds Regime, we are unable to comment whether the proposed illiquidity limit is appropriate for NRIFs, if implemented.

For the reasons cited above, we do not believe it is appropriate to introduce an illiquidity limit for NRIFs at this time.

Non-Guaranteed Mortgages

The Proposals would prohibit NRIFs from investing in any mortgage that is not fully and unconditionally guaranteed by a government or government agency ("**non-guaranteed mortgages**"). 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 this conclusion. We note that CSA Staff Notice 31-323 *Guidance Related to the Registration Obligations of Mortgage Investment Entities* does not discuss the merits of NRIFs investing in non-guaranteed mortgages.

In the context of public mutual funds, the current investment restriction exists because of the illiquid nature of mortgage investments. However, for the reasons stated above, illiquidity is not a sufficient reason to preclude NRIFs from investing in non-guaranteed mortgages since NRIFs are able to match their redemption rights to the liquidity of their investment portfolios. Valuation of non-guaranteed mortgages also is not an issue since the Handbook of the Canadian Institute of Chartered Accountants contains an accounting guideline specifically addressing the valuation of mortgages.

In the absence of an articulated policy concern from the CSA, we are unable to respond further to the CSA's proposal to prohibit NRIFs from investing in non-guaranteed mortgages other than to point out that such a prohibition would effectively preclude Canadian investors from the opportunity to invest in this asset class which has generated attractive returns in the past on a basis uncorrelated with the capital markets. Accordingly, for the reasons cited above, we do not believe it is appropriate to introduce at this time a prohibition on investments by NRIFs in non-guaranteed mortgages.

Organizational Costs

The primary policy reason behind the prohibition against a public mutual fund bearing its organizational costs is that the mutual fund's start-up costs could represent a significant portion of its initial net asset value. We do not believe that the same concern exists with respect to NRIFs since public offerings by NRIFs typically are subject to minimum offering sizes which are at levels sufficient to bear the organizational costs of the NRIF. We suggest that the level of organization expenses should continue to be managed by industry participants through market competition and disclosure to investors.

FASKEN MARTINEAU

We further note that the vast majority of organizational costs relate to compliance with regulatory requirements, meetings with advisors to explain the NRIFs (thereby assisting with Know-Your-Product obligations) and seeking a large offering in order that future fixed operating costs of the NRIF will constitute a proportionately small amount of the NRIF's net asset value. Since the securityholders of the NRIFs ultimately benefit from these matters, it is reasonable for the related organization costs to be indirectly borne by investors through payment out of the offering proceeds.

We believe that shifting organizational costs for NRIFs to managers will not result in cost savings for investors. We specifically disagree with the CSA's suggestion that shifting these costs to managers will create new incentives to reduce the costs. The investment funds industry is highly competitive and managers of investment funds who are unable to minimize the costs borne by their funds are at a competitive disadvantage. Current market practice already limits the organizational costs borne by NRIFs by typically limiting the amount of non-commission expenses that can be charged to the NRIF to 1.5% of the gross proceeds of the initial public offering, with the manager personally bearing any expenses in excess of this limit. Through competition, the industry has ensured that the manager's interests are aligned with those of the investors in its funds to ensure that cost efficiencies are achieved. Accordingly, rather than reducing the amount of organization expenses borne by NRIFs, the Proposals will result in these expenses initially being borne managers, but likely recouped through increased management fees charged to the NRIFs. It also may lead to the introduction of redemption fees.

Imposing organizational costs on managers also would deter managers from creating new funds, which would reduce the number of investment products available to investors. Further, it would impact smaller managers disproportionately, as they would be less able to initially bear these expenses than larger managers. This could reduce the number of participants in the investment industry, which would reduce competition between managers, product choices available to investors, and jobs in the industry.

We also note the CSA's concerns that investment fund managers may launch funds as NRIFs without paying the organizational costs, then later convert those funds into mutual funds as a form of regulatory arbitrage. Rather than eliminate the ability to create NRIFs which bear their organizational expenses, we believe the more appropriate response would be to propose a comprehensive set of a regulations for the conversion of NRIFs to public mutual funds and submit those proposed regulations to public comment.

Warrant and Rights Offerings

We disagree with the position taken by the CSA in the Proposals that would prohibit warrant and rights offerings by NRIFs when the exercise price is at a discount to the net asset value per security. Notwithstanding any dilution to securityholders who do not

FASKEN MARTINEAU

exercise their warrants or rights, these offerings provide benefits to NRIFs and their securityholders. In particular, warrants and rights provide NRIFs with a cost-efficient means of replenishing assets depleted through redemptions, which has the benefits of spreading the fixed operating costs of the NRIF across a large base of assets (thereby reducing the management expense ratio) and increasing the number of outstanding securities of the NRIF (thereby potentially increasing secondary market trading and liquidity for securityholders). It also is fair for securityholders by providing each with an equal opportunity to participate in the offering.

We disagree with the CSA's suggestion that many of the above benefits can be achieved through a follow-on offering of listed securities of the NRIF. In practice, the constating documents of most NRIFs prohibit such offerings unless the net proceeds (e.g. issue price less all offering expenses) are equal to or greater than net asset value per security. This prohibition recognizes that all existing securityholders of a NRIF will not have an equal opportunity to participate in the follow-on offering and may thereby be diluted unfairly. The offering expenses (including agents' commission) for a follow-on offering typically exceed 4% of the issue price. Accordingly, in order to comply with its constating documents, a NRIF can make a follow-on offering only if its securities are trading at a premium of 4% or more to their net asset value per security. This rarely is the case, which is the reason why very few follow-on offerings are made by NRIFs. By comparison, the costs of carrying out a warrant or rights offering are much less than a follow-on offering (due to the absence of a full dealer commission) and all existing securityholders are given an equal opportunity to particulate in the warrant or rights offering. Further, existing securityholders who do not wish to exercise their warrants or rights typically can minimize dilution by selling their warrants or rights in the market prior to expiry.

We understand that current regulations in the United Kingdom permit investment funds equivalent to NRIFs to offer warrants and rights with an exercise price below the net asset value per security. In particular, Listing Rule 15.4.11R(1) provides that unless authorized by its shareholders, a closed-end investment fund may not issue further shares of the same class as existing shares (including issues of treasury shares) at a price below the net asset value per share "*unless they are first offered pro rata to existing holders of shares of that class*." Accordingly, pro rata warrant and rights offerings to existing securityholders of an NRIF are permitted in the U.K. at an exercise price less than the net asset value per security (and can be offered on a basis other than pro rata to existing securityholders if authorized by its shareholders). We also understand that the United States Securities Act of 1940 permits rights and warrants offerings at an exercise price below the net asset value per security provided they are issued to existing securityholders and do not expire more than 120 days after their issuance. If the securities regulators in the U.K and U.S. expressly permit their equivalent investment funds to issue warrants and rights to existing securityholders with an exercise price below the net asset value per

FASKEN MARTINEAU

security, we see no policy rationale for the CSA to differ. Accordingly, we believe that it would not be appropriate to introduce this new restriction until the CSA articulates a policy rationale for diverging from the positions adopted by the securities regulators in the U.K. and U.S.

Lastly, we note that current Canadian securities legislation imposes no equivalent restriction on public companies that are not investment funds. If the CSA consider it acceptable for a public company to issue convertible securities with an exercise price lower than their current market value, we fail to see why a different policy rationale should apply to investment funds. The mere fact that an investment fund is able to calculate its net asset value while a public company cannot is not, in our view, sufficient justification for a difference in regulation.

Fund-on-Fund Investments

The Proposals would require any underlying or "bottom" fund in a "fund-on-fund" structure to be a reporting issuer in each jurisdiction in which its "top" fund is a reporting issuer. We believe that this requirement is unnecessary. It ignores the "principal regulator" concept among the CSA, as well as the fact that all information filed by SEDAR can be accessed by investors through the internet in all Canadian jurisdictions, even if filed with only one CSA member.

The only material consequence of the CSA's proposal is that it would increase the filing fees payable by NRIFs and possibly result in late filing fees for accidental failure to file in all relevant CSA jurisdiction. Assuming that the CSA share the industry's goal of eliminating unnecessary expenses which add to the management expense ratios of investment funds, this is an area where unnecessary costs can be avoided by not introducing this proposed requirement.

Grandfathering

We are concerned that the transition and grandfathering provisions set out in the Proposals would require certain existing NRIFs to change their fundamental nature in order to comply with the new requirements. Existing investors in these NRIFs have purchased their securities (and incurred the related costs) based on the NRIF's current objectives and strategies. We believe it would be unfair to existing securityholders to impose restrictions that would materially impact the NRIF's ability to execute on those objectives and strategies. For this reason, we recommend that existing NRIFs be fully-grandfathered so as to protect the reasonable expectation of existing investors.

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The foregoing comments reflect our current concerns regarding the content of the Proposals and the manner and timing in which the Proposals have been presented. As a result of these concerns, we do not believe it is appropriate for the CSA to implement the Proposals in their current form nor on the proposed timeline. Instead, we believe that further information from the CSA is required to understand the policy rationale, costs and benefits of the Proposals, including the CSA's view on the role of NRIFs through a fully articulated Alternative Funds Regime. Until that occurs, the public consultation process on the Proposals will not be complete.

Yours truly,

Fasken Martineau DuMoulin LLP