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DELIVERED BY EMAIL

August 23, 2013

Mr. John Stevenson
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Ontario Securities Commission
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And to:
- British Columbia Securities Commission
- Alberta Securities Commission
- Financial and Consumer Affairs Authority of Saskatchewan
- Manitoba Securities Commission
- 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

Dear Mr. Stevenson and Ms. Beaudoin:

Re: Proposed Investment Fund Product Regulation Modernization Amendments

This letter sets out the response of Front Street Capital (**FSC**) to the Canadian Securities Administrators' (**CSA**'s) Notice and Request for Comment, released on March 27, 2013 and titled *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**) and to the additional CSA Staff Notice 11-324 dated June 25, 2013 (the **Extension Letter**).

We have not attempted to respond to each of the items in the Proposed Amendments, rather, this letter provides our high level comments on only those items for which immediate comment has been requested, and more particularly as these items pertain to investment funds. We note that other proposals have been referenced, but not yet put forth and we look forward to providing further input as the proposed framework for "alternative" funds (the **Alternative Funds Framework**) develops. We appreciate the opportunity to provide comments as we have serious concerns about the Proposed Amendments that are set out below.

General Comments

Process, Scope and Notice

We are concerned that the scope of the Proposed Amendments is extremely broad and its potential impact is wide-ranging. The Proposed Amendments, if enacted as currently contemplated, would essentially rewrite the entire closed-end fund (**CEF**) regulatory regime and industry. We refer to Staff Notice NI 81-322, issued in May 2011, which indicated that the CSA intended to impose certain restrictions and operational requirements on CEFs to promote investor protection, particularly as they dealt with conflicts of interest, securityholder and regulatory approval requirements (for fundamental changes) and custodial matters. The reach and impact of the Proposed Amendments goes far beyond the matters set out in Staff Notice NI 81-322 and a number of new concepts have been raised for the first time in the Proposed Amendments. Given that these could have a substantial adverse impact on the CEF industry that has developed into a fully functioning market with its own regulatory regime, we would urge the CSA to engage in further consultation before making changes to the CEF regulatory regime.

The Proposed Amendments were surprising to many in their scope. While change is not always a bad thing, we have concerns about the process being followed in considering the Proposed Amendments. For an for an undertaking of this scope and nature, the process should include (i) empirical cost-benefit analysis supporting the proposed changes, (ii) complete disclosure to market participants so that these participants can consider the full impact on investors, business models and product development, and (iii) adequate time for market participants to consider and responds to the proposed changes. Our comments regarding a cost-benefit analysis are set out below under the heading "Empirical Cost-Benefit Analysis". Our concern about the process is that there should have been advanced notice of the Proposed Amendments, which notice should have been accompanied by fulsome details of both the Proposed Amendments and the Alternative Funds Framework. This would have allowed market participants sufficient time and information to provide an informed response, especially if the Alternative Funds Framework will be inter-related with aspects of the Proposed Amendments and are to come into force contemporaneously with the amendments affecting CEFs. On timing and the notice period, we note that the consultation period for the Proposed Amendments is short relative to the consultation period for other initiatives of similar scope and impact in the mutual fund space. On the information provided, we note that it is not possible to properly evaluate a proposal without sufficient details of the alternative framework (i.e. the Alternative Funds Framework) available to be viewed in context of the Proposed Amendments. We would caution against the risks of a "piece-meal" approach to regulation, as such an approach is almost certain to have unintended consequences. Our view is that a sound process drives better results.

Holistic Approach

We strongly echo the views of other commentators who have suggested that it is inherently difficult to comment on the impact of the Proposed Amendments without an understanding of the details of the Alternative Funds Framework. Accordingly, we would urge the CSA to defer consideration of the Proposed Amendments until they can be viewed in tandem with the Alternative Funds Framework.

Empirical Cost-Benefit Analysis

The main purpose of the Proposed Amendments appears to be to require CEFs to comply with the regulatory framework that is applicable to mutual funds, with the stated purposes of "fairness" and to "level the playing field"; however, it is unclear to us how requiring investment products that are currently subject to one regulatory regime (i.e. CEFs) comply with the requirements of another regime (i.e. mutual funds) accomplishes these two stated purposes. We are not aware of any problems that have been clearly identified in the Proposed Amendments that exist in the CEF sphere that would serve as the basis for initiating the Proposed Amendments. There has been no analysis provided of the benefits of such a change, nor has there been a cost-benefit analysis conducted of the risks posed by CEFs that would warrant such a change. We also do not see how this change would either increase investor protection or foster more efficient capital markets. For example, the underwriters and investment dealers involved with CEFs have had rigorous due diligence and approval requirements with respect to the investment restrictions and other features of CEFs prior to the a CEFs initial public offering. These dealers have required certain terms and conditions of CEFs that benefit investors. A CEF prospectus undergoes extensive third-party and regulatory review and comment.

Requiring CEFs to comply with the current mutual fund regulatory regime effectively disregards the reasons leading to the two different regimes (and the extensive accepted market practices evolving around each) in the first place. The fact that the CEF regulatory framework is different to that of the mutual fund framework does not make the former inferior. The Proposed Amendments would not only reduce investor choice, but could have the impact of penalizing CEF investors (who may experience decreased market prices of the securities that they have invested in based on the current regime). We support the CSA view that the costs of regulation should not outweigh the expected benefits. We caution that the Proposed Amendments should not have the effect of substituting regulatory requirements for market discipline and the business judgment and fiduciary obligations of market participants.

The CSA has acknowledged that some of the Proposed Amendments would have the effect of favouring investment fund managers and market participants with significant capital resources, which would result in a CEF market that looks more like the existing mutual fund market (i.e. dominated by a small number of large players). We submit that a market skewed in this fashion would not be conducive to a competitive and innovative environment for the investment funds industry, and that it would likely be detrimental to Canadian retail investors in the long-run.

Unique Qualities of CEFs

As indicated above, CEFs developed under their own regulatory regime. As CEFs go through an initial public offering, are generally listed on a stock exchange, and distributed through IIROC members, certain of the features that are key to mutual funds are not necessarily applicable or of the same benefit to investors of CEFs.

Some examples of this include the following factors:

- Distribution through IIROC dealer members creates an additional layer of oversight by syndicate members in the due diligence and creation of the CEF. These dealer members also ensure the investment is suitable for end-investors.
- CEFs are not offered on a continuous basis, which makes the offering process of a CEF much more complicated and expensive than the creation of a mutual fund.

- The prospectus of a CEF gives rise to civil liability to the issuer any promoter and the investment dealers (encouraging each party to undertake rigorous due diligence in an attempt to avoid such liability). The prospectus for a CEF is also much longer than a mutual fund prospectus and very detailed about all aspects of the CEF, unlike a simplified prospectus and annual information form for a mutual fund. We note that the CSA also has the ability to comment on a proposed CEF through the prospectus review process.
- CEFs trade over an exchange, providing additional liquidity for CEF investors. This results in a different set of considerations with respect to the concentrations and "illiquid asset" concerns that apply to mutual funds.

Clarity Regarding Grandfathering of Existing CEFs

FSC shares the same view regarding "grandfathering" of substantive investment provisions for existing closed-end funds that has been conveyed by other commenters. Uncertainty with respect to this issue will likely have an adverse price impact on existing CEFs (and a corresponding negative impact on current closed-end fund investors). Drastic changes to the investment restrictions that would fundamentally alter the nature of an existing CEF (or require that it be wound-up as it can no longer meet its investment objectives) effectively alters the "bargain" that investors have made by investing based on the prospectus disclosure and the structure of the CEF under the existing regime, and could negatively impact their property rights. If the Proposed Amendments are enacted as currently set out, they could be inconsistent with the expectations and basis for an investor's decision for investing in a CEF (and the business decision of an investment fund manager in launching the CEF). The costs of amending an existing CEF structure to comply with the Proposed Amendments would ultimately be borne by the investor. Significant costs would be incurred by investment fund managers and investors on procedural matters to effect CEF compliance with the Proposed Amendments. Entire marketplaces surrounding the CEF industry will be affected potentially driving portfolio security values down and impacting CEF investors.

We submit that the CSA should protect these property rights and to provide clarity on the grandfathering issue as soon as possible. The uncertainty resulting from the Proposed Amendments impacts not only existing closed-end funds, but also the creation of new funds, as it is unclear at this point how the Proposed Amendments will impact new and existing funds. Our experience with dealer-members has been that the uncertainty has a "chilling" effect on new issues, as the uncertainty may cause investors to adopt a "wait-and-see" approach to investing thereby putting syndicate in the same position. This chilling effect would also impact product innovation and capital-raising. In particular, issuers of CEFs and underwriters of same (i.e. (investment dealers/agents) should know as soon as possible whether they can develop and offer new funds in substantially the same manner as they can currently.

We submit that a transition period for existing CEFs would not be a practical solution as it would require many funds to be wound-up or otherwise converted to be in compliance with the Proposed Amendments giving rise to the negative impact to property rights described above.

Specific Comments

Our specific comments to the Proposed Amendments pertain to (i) investment restrictions, (ii) concentration restrictions, (iii) investments in illiquid assets, (iv) securities lending, repurchases and reverse purchases, (v) fund-of-fund structures and (vi) organizational costs for CEFs.

Investment Restrictions

We submit that the principle of diversification is much more applicable to mutual funds industry than it is for a CEF. CEFs have been developed to use different tools (e.g. leverage and shorting), depending on the nature of the CEF, and its investment objectives and strategy, which are described and disclosed in the relevant prospectus. Indeed, it is the basis on which the securities of the CEF would have been sold and the basis on which an investor invested. CEF investors may not be seeking diversification in a particular fund: they may be seeking exposure to a particular sector or asset. The investment restrictions in the Proposed Amendments do not take into account the potentially specialized nature of a CEF, which must be disclosed at the time that an investor makes the decision to invest, and could reduce innovation and investor choice. The investment restrictions in the Proposed Amendments may also have unintended consequences and should be considered with the Alternative Funds Framework. Please also see our comment above under the heading "Clarity Regarding Grandfathering of Existing CEFs", as the investment restrictions in the Proposed Amendments if enacted as currently contemplated would drastically alter the fundamental nature and investment strategies of many CEFs and may even make some no longer viable.

Concentration Restrictions

As indicated above, the majority of CEFs are exchange-traded. CEFs also typically have an annual redemption right. The concentration restrictions set out in the Proposed Amendments, presumably to address liquidity maintenance concerns, is not applicable to CEFs in the same manner that it applies to mutual funds. While the CSA has noted that many CEFs have self-imposed concentration restrictions, we submit that this limit may not be appropriate in all circumstances (e.g. a CEF that is intended to provide exposure to the Canadian insurance industry). Provided that adequate disclosure is provided in the prospectus, we submit that CEFs should be able to set its own concentration restrictions in accordance with the particular attributes of the CEF and its investment objectives and investment strategies. In our view, the CSA focus should be on ensuring proper disclosure to investors in the prospectus. We also wish to provide the comment that if any concentration restrictions are set for CEFs, then the rules should also provide "look-through" exemption where the economic result is exposure to a broad portfolio of securities.

Investments in Illiquid Assets

Similar to our comment above under the heading "Investment Restrictions", illiquid asset restrictions are not as applicable in the CEF context as they are in the mutual fund context. Mutual funds have a daily redemption at net asset value (**NAV**) that is not applicable to CEFs. A CEF investor's source of liquidity is through trading on an exchange or through the annual redemption right at NAV, reducing the need for daily liquidity. Because of the nature of CEFs, many are intended to provide exposure to specialized sectors, which may involve illiquid investments. If an investor does not want exposure to these sectors, the investor can decide not to purchase the CEF and instead buy a broad-based mutual fund. The purpose or intended result of the Proposed Amendments should not be to reduce investor choice. Instead CEFs should be viewed as an additional tool in an investor's portfolio (together with mutual funds, ETFs, etc.). We are also of the view that the definition of "illiquid asset" should be updated, as there are currently some securities that trade on liquid markets, but which are caught by the definition of "illiquid asset". We submit that a CEFs ability to invest in illiquid assets should be

determined in light of a CEF's investment objectives and strategy and properly disclosed in the prospectus.

Securities Lending, Repurchases and Reverse Purchases

We do not agree that CEFs should have limits on engaging in securities lending, repurchases and reverse repurchases; however, we would support additional disclosure requirements to ensure that investors are properly informed of the CEF's intention to engage in the foregoing and the risks in so doing. We submit that a CEFs ability to engage in securities lending, repurchases and reverse repurchases should be determined in light of a CEF's investment objectives and strategies, and properly disclosed in the prospectus.

Fund-of-Fund Structures

We are of the view that CEFs should be able to obtain exposure to an underlying mutual fund that is not subject to National Instrument 81-102 *Mutual Funds* (**NI 81-102**). In fund-of fund structures, a prospectus has been required for underlying funds to be filed in Ontario and/or Quebec in order to make the underlying funds reporting issuers in those jurisdictions and subjecting the underlying fund to the continuous disclosure requirements of National Instrument 81-106 *Investment Fund Continuous Disclosure* (**NI 81-106**). We submit that this blanket approach is rigid and does not typically provide investors with better information or enhance investor protection. Instead, this approach imposes additional costs and burdens on the underlying funds, which costs are ultimately borne by the investor. We submit that the requirement to file a prospectus for an underlying fund should be examined on a case-by-case basis in light of the substantive elements of a structure and the economics of a transaction. We also submit that, if a reporting issuer becomes an underlying fund in at least one Canadian jurisdiction, there is no additional benefit to be gained by requiring the fund to be made a reporting issuer in all jurisdictions.

Organizational Costs for CEFs

We echo the sentiment of other market participants that requiring an investment fund manager to bear a CEF's organizational costs is a significant departure from the previously adopted position on offering expenses reflected in the amendments to NI 81-102 relating to expenses paid on the launch of an ETF that was not in continuous distribution. The CSA has previously acknowledged that where a one-time offering was made (as is the case for an initial public offering), it would not be prejudicial to the initial investors to reimburse the manager for organizational costs. As indicated above, the process of bringing a CEF to market is substantially more onerous and complex than bringing a conventional mutual fund to market. This complex process involved many steps that benefit the investor and a large portion of the legal, audit, printing, and filing fees are related to regulatory requirements (e.g. the prospectus) aimed at "investor protection". While a mutual fund manager shoulders the costs of creating a new mutual fund, these funds are a fraction of the fees of creating a new CEF. We also note that many mutual fund managers also launch CEFs and submit that requiring a CEF investment fund manager to bear the organizational costs does not "level the playing field", as the products and associated organizational costs are quite different. While mutual fund managers recover launch costs through ongoing management fees, we note that mutual fund management fees are typically higher than those of CEFs. If a CEF were to increase a management fee with a view to recovering launch costs (rather than having the CEF cover the launch costs), investors may pay more in the long-run, since the management fees are ongoing.

Conclusion

We appreciate the opportunity to comment on the Proposed Amendments. We are very concerned about not only the process undertaken to review and consider the Proposed Amendments, but also scope and impact of the Proposed Amendments. We strongly urge the CSA to consider the development of amendments to the Alternative Funds Framework while letting the current CEF regulatory regime continue as these amendments take are developed. We agree with the approach of increasing the scope of National Instrument 81-104. If the CEF regulatory regime is revised, it should be done in the context of the overall markets and not simply be made the same as the regulatory regime applicable to mutual funds. In our view, CEFs should be viewed as a complement to, and not a substitution for, mutual funds.

Yours sincerely,

FRONT STREET CAPITAL 2004

Per: Terence Lui, General Counsel