Alternative Investment Management Association (AIMA)

The Forum for Hedge Funds, Managed Futures and Managed Currencies

March 9, 2016

British Columbia Securities Commission
Alberta Securities Commission
Financial and Consumer Affairs Authority of Saskatchewan
The Manitoba Securities Commission
Ontario Securities Commission
Autorité des marchés financiers
Financial and Consumer Series Commission (New Brunswick)
Office of the Superintendent of Securities, Prince Edward Island
Nova Scotia Securities Commission
Office of the Superintendent of Securities, Newfoundland and Labrador
Office of the Superintendent of Securities, Northwest Territories
Office of the Yukon Superintendent of Securities
Office of the Superintendent of Securities, Nunavut

Me Anne-Marie Beaudoin
Corporate Secretary
Autorité des marchés financiers
800, rue du Square-Victoria, 22 étage
C.P. 246, tour de la Bourse
Montréal, Québec H4Z 1G3
Fax : 514-864-6381
email: consultation-en-cours@lautorite.qc.ca

The Secretary
Ontario Securities Commission
20 Queen Street West,
22nd Floor
Toronto, Ontario M5H 3S8
Fax: 416-593-2318
Comments@osc.gov.on.ca

Dear Sirs/Mesdames:

Re: Canadian Securities Administrators ("CSA") Notice and Request for Comments - CSA Mutual Fund Risk Classification Methodology for Use in Fund Facts and ETF Facts (the "Proposal")

This letter is being written on behalf of the Canadian section ("AIMA Canada") of the Alternative Investment Management Association ("AIMA") and its members to provide our comments to you on the legislation referred to above.

Although the Proposal does not directly impact our members who do not manage mutual funds and exchange traded funds in addition to alternative funds, we are providing our comments given the potential future application of the Proposal to Modernization of Investment Fund Product Regulation – amendments to National Instrument 81-104 *Commodity Pools* (the "Alternative Funds Framework").

The predecessor of the Proposal was published on December 12, 2013 by the CSA in CSA Notice 81-324 and Request for Comment *Proposed CSA Mutual Fund Risk Classification Methodology for Use in Fund Facts* (the "2013 Proposal"). At the time, AIMA Canada submitted a comprehensive comment letter in response to the various questions posed under the 2013 Proposal. Now, as securities regulators are working towards publishing an instrument implementing the Alternative Funds Framework, the future effect of the Proposal on alternative funds should be carefully considered.

In addition, the Proposal could have more immediate implications on our members who may choose to adopt the Proposal methodology in their private funds even though they are not required to do so.

About AIMA

AIMA was established in 1990 as a direct result of the growing importance of alternative investments in global investment management. AIMA is a not-for-profit international educational and research body that represents practitioners in hedge fund, futures fund and currency fund management – whether managing money or providing a service such as prime brokerage, administration, legal or accounting.

AIMA's global membership comprises over 1,600 corporate members in more than 50 countries, including many leading investment managers, professional advisers and institutional investors. AIMA Canada, established in 2003, now has more than 130 corporate members.

The objectives of AIMA are to provide an interactive and professional forum for our membership and act as a catalyst for the industry's future development; to provide leadership to the industry and be its pre-eminent voice; and to develop sound practices, enhance industry transparency and education, and to liaise with the wider financial community, institutional investors, the media, regulators, governments and other policy makers.

The majority of AIMA Canada members are managers of hedge funds and fund of funds. Most are small businesses with fewer than 20 employees and $50 million or less in assets under management. The majority of assets under management are from high net worth investors and are typically invested in pooled funds managed by the member. Investments in these pooled funds are sold under exemptions from the prospectus requirements, mainly the accredited investor and minimum amount exemptions. Manager members also have multiple

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registrations with the securities regulatory authorities: as Portfolio Managers, Investment Fund Managers and in many cases as Exempt Market Dealers. AIMA Canada's membership also includes accountancy and law firms with practices focused on the alternative investments sector.

For more information about AIMA Canada and AIMA, please visit our web sites at canada.aima.org and www.aima.org.

Summary and Overview

We acknowledge and appreciate the CSA's recognition of the desirability of establishing a standardized risk classification methodology to facilitate investor comparisons of the risks of investing in different mutual funds and alternative funds. We also believe that using reference indices when performance history does not exist is generally a good idea. However, imputing returns based on a reference index is by nature an imperfect exercise and it is important to be aware of the limitations of such an approach. We see the following issues in applying the Proposal, and specifically the use of reference indices, to the Alternative Funds Framework:

1. There may be no relevant reference indices for certain actively managed strategies that are highly dependent on decisions of individual fund managers (e.g. merger arbitration, equity market neutral).
2. Seemingly applicable indices comprised of funds with similar strategies may be misleading.
3. It may not be possible for funds with certain actively managed strategies to comply with all the principles for selecting a reference index specified by the CSA.
4. In most cases there will be no performance history when the Alternative Funds Framework is launched.
5. The 10-year timeframe required to assess risk is too long.

These issues are expanded upon below along with suggestions for adaptation to the Alternative Funds Framework.

1. Some alternative investment funds may have no relevant reference index

We see there being three different categories of fund strategies, with the first two being amenable to reference indices and the third not.

First, there are rules-based strategies that can be easily back-tested (such as index-tracking funds and passive exchange traded funds). Second, there are simple active management strategies that consist of choosing which assets from a certain sector or geographic area to buy and hold (actively managed long only funds). While these strategies cannot be back-tested, an index that represents a certain asset class within a sector or geographic area can serve as a rough proxy. This is because traditional mutual fund managers choose which assets to buy and hold from the asset class or geographic region in which they have chosen to invest. Since they must choose a large enough number of these assets in order to be properly diversified, the portfolio returns end up somewhere close to their relevant reference index.

The third category of strategies are complex active management strategies for which the day-to-day decisions of individual fund managers are the dominant influences on returns (e.g. merger arbitration, equity market neutral, long/short equity, commodities trading advisors ("CTAs") etc.). Most alternative investment funds will fall into this third category. These types of strategies cannot be back-tested and also likely have no appropriate index that could serve as a proxy for their performance. This is because the returns of alternative investment funds will not have the same relationship to a certain pool of assets like a conventional mutual fund. Strategies of alternative investment funds are generally highly dependent on the decisions of the individual fund managers. While all of the assets they decide to trade may come from a certain pool, the average return of their holdings will not bear any significant resemblance to the average return of the pool.

The only type of index that could potentially be relevant for alternative investment funds in this third category is an index comprised of other funds with substantially similar strategies (a "Similar Funds Index"). However, as described below, these types of indices have several problems that compromise their effectiveness.

2. Seemingly applicable indices may be misleading

Even if there exists a seemingly applicable Similar Funds Index for an alternative mutual fund, the index itself is likely to be uniquely problematic in a way that reference indices for conventional mutual funds are not.

First, the dataset for some Similar Funds Indices is too small to be statistically significant. For example, the Scotiabank CTA index is comprised of only five funds.

Second, some relevant Similar Funds Indices (for example, the Scotiabank group of hedge fund indices) are only made up of funds that volunteer to be included. This creates selection bias, as both top-performing funds and bottom-performing funds will often not volunteer their data for the index. The ultimate volunteers are more likely to be middle-performing funds, which will result in a smoothing of the index and therefore an inaccurate proxy for risk.

Finally, and most importantly, there is too much dispersion of individual fund

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performance around the performance of the Similar Funds Index. Even within a particular strategy, returns may be completely uncorrelated between different sub-strategies (such as merger arbitration in the pharmaceutical sector versus the energy sector or such as between equity market neutral in Canada versus emerging markets). Many alternative investment funds pursue very niche sub-strategies and there are simply not enough funds engaged in each sub-strategy to create meaningful targeted Similar Funds Indices.

Given these limitations, we discuss recommendations in the following three sections below.

3. Difficulty Complying with the CSA's Reference Index Principles

The Proposal indicates that a fund manager should choose a reference index that meets the following principles:

(a) is made up of one or a composite of several market indices that best reflect the returns and volatility of the mutual fund and the portfolio of the mutual fund;
(b) has returns highly correlated to the returns of the mutual fund;
(c) contains a high proportion of the securities represented in the mutual fund's portfolio with similar portfolio allocations;
(d) has a historical systemic risk profile highly similar to the mutual fund;
(e) reflects the market sectors in which the mutual fund is investing;
(f) has security allocations that represent invested position sizes on a similar pro rata basis to the mutual fund's total assets;
(g) is denominated, in or converted into, the same currency as the mutual fund's reported net asset value;
(h) has its returns computed on the same basis (e.g., total return, net of withholding taxes, etc.) as the mutual fund's returns;
(i) is based on an index or indices that are each administered by an organization that is not affiliated with the mutual fund, its manager, portfolio manager or principal distributor, unless the index is widely recognized and used; and
(j) is based on an index or indices that have each been adjusted by its index provider to include the reinvestment of all income and capital gains distributions in additional securities of the mutual fund.

It may be difficult or impossible for alternative investment funds with certain actively managed strategies to satisfy *all* of these principles.

For example, principles (b) and (d) above relate to the correlation of fund returns to index returns. As described above, certain actively managed strategies are executed by different fund managers in such diverse ways that there will be no significant correlation between the fund returns and the returns

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of a Similar Funds Index. The most obvious example of this issue is a CTA strategy, which may use derivatives in a completely different way from another CTA strategy fund while still being grouped together with that fund in a Similar Funds Index.

For example, principles (c) and (f) above relate to the portfolio allocations of the fund versus the portfolio allocations in the index. However, in the case of a Similar Funds Index, portfolio allocations for such an index will likely not be available as the individual funds which comprise the index will not volunteer such information. Therefore, fund managers may not have sufficient information to comply with principles (c) and (f) when choosing a Similar Funds Index as a reference index.

We recommend that where certain principles from the list are difficult or impossible to satisfy, a carve-out exemption from such principles should be considered by the CSA in relation to the Alternative Funds Framework.

In addition, the CSA indicated that blended indices could be used to create a reference index. We submit that it would be helpful if the instructions in the final rule would clarify that indices could be blended on both an asset-weighted basis (e.g. 70% weight on a equity index and 30% weight on a bond index) and a temporally-divided basis (e.g. switching from one index to another when the first index no longer exists). This would assist alternative investment funds in satisfying the CSA's reference index principles.

4. No performance history when Alternative Funds Framework is launched

Once the Alternative Funds Framework is introduced, the alternative investment funds that emerge will in most cases have no performance history. This will mean that, in the absence of an exception, these new alternative investment funds will have to rely solely on reference indices to determine their risk rating.

In practice, a large number of these new alternative investment funds will be launched by fund managers who already manage investment funds using substantially similar strategies that are offered through an offering memorandum ("OM Funds"). We believe that a new alternative investment fund should be able to use a related OM Fund's previous performance history to calculate its risk rating if the OM Fund has the same manager and substantially the same strategy. This will provide a much more accurate proxy of risk than relying on a reference index.

5. The 10-year timeframe required to assess risk is too long

We submit that a 10-year period of performance required to assess risk is too long. New alternative investment funds will have either no performance history

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or, if our suggestion regarding related OM Fund history is taken into account, only a few years of performance history.

While using a reference index to fill in the performance gaps for mutual funds under the Proposal already presents difficulties, these difficulties are magnified significantly when reference indices are applied to alternative investment funds without any track record. See the section above titled “Seemingly applicable indices may be misleading”.

In the case of most alternative investment funds, we believe that the less a reference index is used, the more accurate the risk rating will be. Therefore, we recommend shortening the mandatory performance history period to the greater of 5 years and the actual number of years the fund has been in existence (taking into account the performance history of related OM Funds). We note that the CESR Guideline for UCITS funds requires only a 5-year period.

Conclusion

In summary, we agree with the CSA’s objective of establishing a standardized risk classification methodology to facilitate investor comparisons of the risk of investing in different mutual funds. However, since certain actively managed strategies may not have a relevant or reliable reference index, we note the following points and recommendations regarding the potential future application of the Proposal to the Alternative Funds Framework:

- Since it may not be possible for alternative investment funds with certain actively managed strategies to satisfy certain of the reference index principles, the CSA should consider a carve-out exemption from such principles in relation to the Alternative Funds Framework.
- Since new alternative investment funds will have no performance history when the Alternative Funds Framework is launched, we submit that these new alternative investment funds should be able to use a related OM Fund’s previous performance history to calculate their risk rating if the OM Fund has the same manager and substantially the same strategy.
- Given the anticipated lack of performance history for new alternative investment funds and the issues with using a reference index for certain actively managed strategies, the 10-year time period required to assess risk is too long. We recommend a 5-year time period.

We appreciate the opportunity to provide the CSA with our views on the Proposal. Please do not hesitate to contact the members of AIMA set out below with any comments or questions that you might have.

Ian Pember, Hillsdale Investment Management Inc.
Co-Chair, Legal & Finance Committee, AIMA Canada
(416) 913-3920
ipember@hillsdaleinv.com

Jennifer A. Wainwright, Aird & Berlis LLP
Co-Chair, Legal & Finance Committee, AIMA Canada
(416) 865-4632
jwainwright@airdberlis.com

Jason A. Chertin, McMillan LLP
Legal & Finance Committee, AIMA Canada
(416) 865-7854
jason.chertin@mcmillan.ca

Yours truly,

ALTERNATIVE INVESTMENT MANAGEMENT ASSOCIATION

By:

Ian Pember
On behalf of AIMA Canada and the Legal & Finance Committee