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British Columbia Securities Commission
Alberta Securities Commission
Financial and Consumer Affairs Authority of Saskatchewan
Manitoba Securities Commission
Ontario Securities Commission
Autorité des marchés financiers
Financial and Consumers Services Commission, New Brunswick
Superintendent of Securities, Department of Justice and Public Safety, Prince Edward Island
Nova Scotia Securities Commission
Securities Commission of Newfoundland and Labrador
Registrar of Securities, Northwest Territories
Registrar of Securities, Yukon Territory
Superintendent of Securities, Nunavut

The Secretary
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– and –

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RE: Response to Canadian Securities Administrators ("CSA") Notice and Request for Comment – Modernization of Investment Fund Product Regulation – Alternative Funds (the "Proposed Rules")

Dear Sirs/Medames:

We are pleased to provide the CSA with comments on the recently published Proposed Rules, which would repeal National Instrument 81-104 *Commodity Pools* ("**NI 81-104**") and propose a number of amendments to National Instrument 81-102 – *Investment Funds* ("**NI 81-102**"), as they reflect issues that directly impact the registrants we service.

AUM Law is a boutique securities law firm with offices in Toronto and Montreal, providing regulatory compliance, fund formation, and corporate finance advice. We deliver practical and forward-thinking advice and services to our clients, consisting primarily of portfolio managers, fund managers and exempt market dealers.

The comments in this letter represent the personal views of the undersigned lawyers and are not necessarily the views of AUM Law. This comment letter is submitted without prejudice to any position that has or may in the future be taken by AUM Law on its own behalf or on behalf of its clients.

We believe the Proposed Rules are a welcome development in the expansion of access to the alternative fund market for retail investors. In particular, we support the CSA's goal of streamlining and modernizing the rules applicable to investment funds (specifically with respect to the form of alternative fund disclosure documents), as well as the streamlining of proficiency requirements for mutual fund dealers.

We are concerned, however, that certain of the proposed amendments may have unintended effects. In particular, we have questions and comments regarding the following issues.

1. Leverage Limits

Though we are supportive of the permitted use of additional leverage by alternative funds under the Proposed Rules, we have some specific concerns that have been raised to us by clients in relation to certain strategies.

The Proposed Rules would regulate alternative funds with a broad spectrum of strategies and risk profiles. The leverage restrictions in the Proposed Rules, however, appear to some to favour equity strategies that rely on the use of derivatives for leverage over managers using fixed-income or debt strategies. In particular, the Proposed Rules require:

A. that the aggregate gross exposure by an alternative fund or a non-redeemable investment fund, through borrowing, short-selling or the use of specified derivatives cannot exceed three (3) times the fund's net asset value (the "**NAV**"). This would be the aggregate of (a) the total amount of outstanding cash borrowed + (b) the combined market value of securities it sells short, and (c) the aggregate notional amount of its specified derivatives positions, including those used for hedging purposes;

B. that alternative funds limit borrowing up to 50% of their NAV; and

C. that the combined use of short-selling and cash borrowing by alternative funds be subject to an overall limit of 50% of NAV.

As a result, an alternative fund could use specified derivatives up to 300% of its NAV whereas an alternative fund that only borrowed cash and utilized short selling could leverage itself up to only 50% of its NAV. The Proposed Rules appear to some to restrict strategies that rely on cash borrowing and short-selling for leverage and favour strategies reliant on derivatives, the implication being that strategies reliant on borrowing cash and short selling are inherently riskier than those using derivatives for leverage.

As a consequence, investment fund managers may be forced to use riskier forms of leverage for funds with strategies that would typically rely on more than 50% of NAV. Some alternative funds sold to retail investors which can abide by the Proposed Rules may thus have inherently risker profiles than an alternative fund which was allowed to borrow cash or short-sell in excess of 50% of their NAV, as a fund manager may utilise riskier derivatives or instruments that they would not otherwise choose to use.

One potential solution is to consider the risk classification of the alternative fund. The CSA could permit two different tiers of restrictions using the new *CSA Mutual Fund Risk Classification Methodology for the Use in Fund Facts and ETF Facts*. A lower leverage restriction could be set for alternative funds rated "Medium to High" or "High", which may include some equity strategies dependant on the use of derivatives. Alternative funds ranked "Low," "Low to Medium" or "Medium," which could include those with credit strategies that rely on short-selling and cash borrowing and deal in securities that are not high-risk in terms of price fluctuation, could be permitted additional leverage.

As risk associated with leverage varies across asset class, this should be reflected in the Proposed Rules. A hard leverage limit, as set out in the Proposed Rules, does not provide investors with a clear and complete understanding of risk associated with leverage and may limit the types of alternative fund strategies that are available for retail investors. As noted above, we suggest that that CSA include a requirement for explicit disclosure of why the particular leverage "tier" is applicable.

2. Exclusions from Leverage Calculation

We propose that the CSA consider carving out specified derivatives and short sales used for hedging purposes from the 300% aggregate leverage calculation for alternative funds. It seems inaccurate to classify these instruments as "leverage" when they are used for hedging, as hedges are generally intended to reduce the overall risk in the portfolio.

We understand the CSA has previously considered this issue, but as it remains an area of concern for a number of alternative portfolio managers, we request that the CSA give the issue further consideration.

3. Counterparty Requirements

The Proposed Rules require an alternative fund to limit its mark-to-market exposure with any one counterparty to 10% of NAV. The Proposed Rules also exempt an alternative fund from the prohibitions that commodity pools are currently subject to under NI 81-104. This prohibition prevents such funds from entering into certain derivative transactions where either the derivative itself, or the counterparty (or the counterparty's guarantor), does not have a "designated rating" as defined in NI 81-102.

We understand that this proposed exemption is intended to facilitate access to more counterparties in order to accommodate the new proposed counterparty requirements. However, the proposed counterparty requirements may nevertheless be too administratively cumbersome and costly for certain alternative funds.

For example, we have been informed that a borrowing agent typically requires that the proceeds from a short sale, plus additional collateral, be held by the borrowing agent as security. Therefore, an alternative fund that wishes to take full advantage of the proposed limit of short selling up to 50% of its NAV would have to contract with six or more borrowing agents to maintain a 10% maximum with each. This could lead to operational and administrative inefficiencies and an increase in the operational costs of the fund.

As the counterparty requirements for alternative funds may be disproportionately restrictive and costly for alternative funds that rely on a strategy of short-selling securities, we ask that the CSA give further consideration to these requirements.

4. Borrowing

The proposed changes to subsection 2.6(2)(a) of NI 81-102 state that "the alternative fund or non-redeemable investment fund may only borrow from an entity described in section 6.2". Although it is implied from the surrounding language that this section relates to "cash borrowing," and not the borrowing of securities in connection with a short sale, if this is the intention then we request that this subsection be clarified to state that the alternative fund ".... may only borrow **cash** from an entity..."

We thank you for the opportunity to comment on the Proposed Rules. Please do not hesitate to contact any of the undersigned should you have any questions or wish to discuss our comments further.

Sincerely,

AUM LAW PROFESSIONAL CORPORATION

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