Borden Ladner Gervais LLP
Bay Adelaide Centre, East Tower
22 Adelaide St. W.
Toronto, Ontario, M5H 4E3
T 416.367.6000
blg.com

Borden Ladner Gervais

December 22, 2016

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Nova Scotia Securities Commission
Securities Commission of Newfoundland and Labrador
Registrar of Securities, Northwest Territories
Registrar of Securities, Yukon Territory
Superintendent of Securities, Nunavut

Delivered to:

The Secretary
Ontario Securities Commission
20 Queen Street West
22nd Floor
Toronto, ON M5H 3S8
comments@osc.gov.on.ca

Me Anne-Marie Beaudoin
Corporate Secretary
Autorité des marchés financiers
800, square Victoria, 22e étage
C.P. 246, tour de la Bourse
Montréal, Québec H4Z 1G3
consultation-en-cours@lautorite.qc.ca

Dear Sirs/Mesdames:

Re: CSA Notice and Request for Comment

Modernization of Investment Fund Product Regulation – Alternative Funds published for comment September 22, 2016

We are lawyers in the Investment Management practice group of Borden Ladner Gervais LLP and we work with many fund managers and their investment funds (mutual funds, closed-end funds and ETFs) that are regulated by National Instrument 81-102 *Investment Funds* (NI 81-102), as well as with fund managers and their commodity pools that are now regulated by NI 81-102 and National Instrument 81-104 *Commodity Pools* (NI 81-104). We also act for many fund managers and their investment funds that today are not regulated by NI 81-102, because those fund managers have chosen not to qualify their securities for sale to the public, given the restrictions that would apply to them under NI 81-102 if they chose to do so. Many of those fund managers did not wish to take advantage of NI 81-104 for various reasons, including the fact that there are significant distribution challenges and rather onerous consequences of being considered a "commodity pool" under that instrument.

We have closely followed and commented on the numerous changes to NI 81-102 that have been proposed and implemented in the past number of years, and have strongly supported the CSA in its efforts to develop an alternative funds regime.

We note that our lawyers participated in various working groups of industry associations to assist them in developing their comment letters. Michael Burns is the Chair of the Alternative Investment Management Association (AIMA) and provided input into our letter, as well as into the AIMA letter. We also participated in the working groups and reviewed the comment letters of The Investment Funds Institute of Canada and the Portfolio Management Association of Canada while finalizing our letter.

We are pleased to provide our views on the most recent proposals for amendments to NI 81-102 and the related instruments, and support the concepts behind the proposed alternative funds regime. Our comments highlight some amendments that we consider should be made for clarity and/or to allow for practical adoption and implementation of the regime by industry participants, so as to achieve the objectives of the CSA, which we understand to be enhancing investment opportunities for investors by allowing for access to liquid alternative investment asset classes and strategies. In our view, the proposed alternative funds regime will provide Canadian retail investors with access to more innovative investment strategies, which are still appropriate from a risk perspective, while also providing them with useful disclosure that is suited to the specific type of investment vehicle.

We greatly appreciate the practice of the CSA over the past few years to publish blacklined copies of the instruments being amended. This significantly enhances our ability to grasp the significance of what is being proposed and allows us to more easily provide comments to the CSA.

Our comments should not be taken as the views of BLG, other lawyers at BLG or our clients.

We provide our comments in the order of the various instruments, and their provisions, that were published for comments. We have chosen to answer certain of the CSA's questions where we feel we have particular expertise and experience.

Comments on NI 81-102 Amendments

1. Commentary on division of NI 81-102 into rules relating to "alternative funds", mutual funds and non-redeemable investment funds

Overall we agree with the proposals of the CSA to divide the world of publicly offered investment funds into these broad categories, although we note that there are a number of different sub-sets of these categories, each with slightly different requirements and some of which are overlapping. We recommend that the CSA consider a discussion in the Companion Policy about these categories and the implications of being one or the other. Please see also our comments below on the definition of "non-redeemable investment fund".

We prepared for our clients a table indicating the various requirements that will apply to each type of investment fund, if the amendments are adopted, which may serve as a useful format for the Companion Policy. Our Investment Management Bulletin accompanies this letter.

2. Part 1 – section 1.1 - Definition of "alternative fund"

In answer to the CSA's first question about replacing the term "commodity pool", with "alternative fund", we strongly agree that the term "commodity pool" is a misnomer and is not readily understandable by investors, whereas "alternative fund" is more comprehensible and plainly stated.

As currently drafted in the proposed amendments to NI 81-102, it is the fundamental investment objective of the mutual fund that determines whether a mutual fund is an alternative fund, by either allowing for investment in asset classes or by the adoption of investment strategies that would not otherwise be permissible. However, in many cases, it is the investment *strategies* of a fund, and not the investment objective, per se, that makes a mutual fund an alternative fund. Accordingly, the definition of "alternative fund" should be revised to make it clear that an alternative fund is a mutual fund that has adopted either fundamental investment objectives or investment strategies that permit it to invest in asset classes or financial instruments in a manner that is otherwise prohibited by Part 2 of NI 81-102, but for prescribed exemptions. If the CSA consider that the definition works as drafted, then we recommend that further discussion of this point be included in the Companion Policy to NI 81-102 so as to alleviate any confusion.

We also note from the CSA's commentary in the response to comments and generally in the CSA notice that there is no intention (at present) for the CSA to implement required naming conventions for alternative funds; for example, by requiring the fund names to highlight that the funds are "alternative funds". We agree with this approach. However, we strongly recommend that the CSA commentary in the response to comments be included in section 2.01 of the Companion Policy of NI 81-102 for future clarity and on-going understanding, given that CSA statements in Notices become increasingly difficult to find in years following a rule's adoption.

We point out that the CSA may wish to discourage future conventional mutual funds from using the word "alternative" in their names and in the description of their investment strategies. We are not aware that this practice is wide-spread, but we consider that this is a point that the CSA may wish to make in the Companion Policy, so as to avoid any uncertainty in the minds of investors (and their advisors) as to the status of the particular fund. Any conventional mutual fund that currently has the word "alternative" in its name may wish to consider changing or supplementing its name to ensure clarity. This name change should not require a securityholder vote and should not be considered to be a material change; we recommend that the CSA emphasize this point.

We also recommend that the CSA add a brief paragraph to section 2.01 of the Companion Policy clarifying that it is not intended that all "precious metals funds" are alternative funds; that is, simply because precious metals funds invest in one or more precious metals does not mean that they fall within the definition of alternative fund. There has to be more to the fund than simply investing in precious metals. It would be helpful to clarify that an alternative fund *could* include a fund that invests in precious metals provided there are other investment objectives and/or strategies followed by that fund that brought it within the alternative fund world.

Related to our comments on the "alternative funds" definition, we have considered the CSA's second question – namely whether there are particular asset classes common under typical alternative investment strategies, but have not been contemplated for alternative funds under the amendments.

We understand that many in the industry would like the CSA to move towards a better recognition of the place that "market neutral" strategies have in an investing strategy for investors.

The investment objective of a market neutral strategy is to remove market risk (i.e. the risks of significant swings in the market) by balancing long and short positions in an effort to provide returns in all market conditions. A market neutral strategy can provide true diversification in an investment portfolio, as it is intended to be uncorrelated to the market. However, in order to employ a market neutral strategy, a fund must be permitted to have short and long positions of up to 100% of net asset value (NAV). Given the maximum short position limit of 50% of NAV suggested for alternative funds in section

2.6.1(c)(v) of NI 81-102, it will be difficult for a pure market neutral investment strategy to be offered as an alternative fund under this instrument.

Although it may be technically possible for an alternative fund to replicate a market neutral strategy under the proposed amendments through the use of short-selling and specified derivatives, such an approach would be inefficient and more costly to implement.

We submit that market neutral strategies can play an important role in removing market risk in an investor's portfolio and should be permissible as an alternative fund under NI 81-102. An exemption could be made to the proposed 50% of NAV short sale limit for funds that hold themselves out as market neutral. This would permit such a fund to have short positions up to 100% of NAV.

3. Part 1 – section 1.1 - Definition of "cleared specified derivative"

The definition of "cleared specified derivative" does not distinguish between two of the principal participants in the derivatives industry: the futures commission merchants that execute and clear exchange-traded derivatives and the clearing corporations that clear over-the-counter derivative transactions. While the blurring of these distinct functions may currently work as drafted, we submit that as new derivative rules continue to be refined and to come into effect in Canada, it will be necessary to distinguish between exchange-traded derivatives and cleared derivatives under NI 81-102. We suggest that the definition of cleared specified derivative be split into two definitions, as follows:

(a) "cleared specified derivative" means a specified derivative that is cleared through a regulated clearing agency

(b) "exchange-traded specified derivative" means a specified derivative that trades on a futures exchange or an options exchange and that is executed and cleared through a dealer that is registered or exempt from registration under the laws of the jurisdiction of the mutual fund.

4. Definition of "non-redeemable investment fund"

We strongly recommend that the CSA take the discussion about what is (and is not) a non-redeemable investment fund that is presently found in NI 81-106 and its Companion Policy and include it in NI 81-102 and its Companion Policy, so that this instrument can be an all-encompassing instrument and a "one-stop" shop for understanding the CSA's division of the public fund universe. Some participants do not think to look to the Companion Policy of NI 81-106, and we feel that the industry and their advisers, alike, will benefit from this amendment. We recognize that NI 81-106 also needs to have this discussion, given that it applies to public and private issuers and the latter issuers need to understand if they are "investment funds" or not.

We also recommend that the CSA consider updating the NI 81-106 Companion Policy discussion, particularly as it relates to clarifying the recent thinking about what investment vehicles the CSA considers NOT to be an investment fund, which has been subject of some consternation within the industry and the legal community, and, in our view, deserves public consultation. Some of the discussion that is in section 1.3 of the Companion Policy to NI 31-103 and CSA Staff Notice 81-722, for instance, as it relates to private equity and venture funds, as well as mortgage investment entities, could be usefully incorporated into the Companion Policy to NI 81-102 (and NI 81-106, if the discussion is duplicated), to clarify that these funds (if publicly offered) are not considered to be investment funds and are not subject to the rules of NI 81-102. This area (that is, what is and what is not an investment fund) is generally poorly understood; we would be very pleased to discuss this issue further with CSA staff.

5. Section 2.3

In our view, subsection (4) does not work as the CSA appear to intend or if it does, it's a somewhat meaningless exclusion in our view. We understand the "look through" test in subsection (3), but we believe that a top fund should be able to exclude an investment by ANY investment fund (not just an IPU or a stock or bond index) that the top fund invests in, if that investment represents less than 10 percent of the NAV of that underlying fund. In our view, it does not make sense to restrict subsection (4) to underlying IPU investments or stock or bond indices.

6. Section 2.4

We note the CSA's intention to consider further rules, including risk management techniques relating to liquidity risk management for investment funds, which is mentioned in the CSA Notice and Request for Comment and would welcome the opportunity to provide input into this discussion at an appropriate time. We consider that there is a real need for further clarity and thought on this issue. In our view, this topic and the scope of the definition of illiquid assets deserves further commentary and consultation not necessarily tied to the alternative funds proposals.

7. Section 2.6

As a drafting matter, subsection (1) should be made subject to subsection (2) for alternative funds and non-redeemable investment funds. In addition, subsection (2) should clarify that an alternative fund and a non-redeemable investment fund may grant security interests over any of their portfolio assets in connection with borrowings that are permitted under this subsection. This is specifically permitted under subsection (1), but not subsection (2), which it should be.

More substantively, we consider that borrowing from a related party is not such an insurmountable conflict of interest – it is certainly not otherwise prohibited - that this practice deserves IRC "approval", as opposed to a positive recommendation. We note that many in the fund industry enter into related party agreements, such as portfolio management or other services provision, where IRC "approvals" are not contemplated. We do not view a borrowing arrangement to be materially different from these other related party services agreements.

In our view, subparagraphs (a) and (b) of subsection (2) should be drafted with the following changes for clarity and consistency:

(a) The alternative fund or non-redeemable investment fund ~~may only~~ borrows from an entity described in section 6.2 and section 6.3 [see further below]

(b) If the lender is an affiliate [or associate? *– see further page 8174 of the OSC Bulletin edition of the CSA Notice – Section 6 of the amendments to NI 81-101 refers to "associates"*] of the investment fund manager of the alternative fund or non-redeemable investment fund, the independent review committee of the alternative fund or non-redeemable investment fund must provide a positive recommendation to proceed with ~~has approved~~ ~~must approve~~ the applicable borrowing agreement after such proposed lending arrangement has been referred to the IRC under subsection 5.1 of NI 81-107.

We also urge the CSA to permit alternative funds to borrow from non-Canadian lenders, which we understand is a common practice for alternative funds so as to allow for more efficiencies relating to loans in foreign currencies to allow for transactions in those foreign currencies.

8. Section 2.6.1

Please see our references to market neutral funds in connection with our comments on the definition of "alternative funds" in comment 2 above. This section should be modified to permit these strategies.

We also consider that there is a need to exclude government securities and IPUs from the single issuer "short selling" limits provided for in paragraph 2.6.1 (1)(c)(ii) and (iv). This exclusion is just as relevant for short selling as it is for long positions and should apply to all types of investment funds in this context, as it does for long positions.

9. Section 2.6.2

Please see our references to market neutral funds in connection with our comments on the definition of "alternative funds" in comment 2 above. This section should be modified to permit these strategies.

10. Section 2.7(4) (5)

We consider that alternative funds and non-redeemable investment funds should be exempt from these provisions (counterparty exposure).

It is not clear to us that there is any risk from exposure to a single counterparty that needs to be mitigated. We submit that, under section 2.7(4) of NI 81-102, the calculation of the mark-to-market value of the exposure of an investment fund to a counterparty should be net of credit support provided by the counterparty. This is because the provision of credit support eliminates the credit risk of the counterparty. We note that such credit support is commonly required under most derivative transactions and rules are currently being drafted and implemented that will make the posting of collateral mandatory under most over-the-counter derivative transactions.

11. Section 2.9.1

We agree that it is important for an investor to understand the amount of leverage in the portfolio of an alternative fund or a non-redeemable investment fund. For this reason, the leverage calculation should be as simple as possible. While a leverage calculation based on the aggregate notional amount of an investment fund's specified derivatives position may be simple to understand, we submit that this calculation results in a distorted view of the fund's actual exposure under its derivatives positions. In most cases, a fund's liability under its derivatives positions is significantly less than the notional amount of those derivatives. In addition, if a leverage limit is imposed on these investment funds to mitigate risk, then specified derivatives that are entered into for offsetting hedging purposes in order to reduce a risk in the portfolio should not be included in the leverage calculation. In order to not unduly restrict the investment strategies of these funds, we submit that it would be more appropriate to only require disclosure of the leverage ratio of the funds, and not to impose a limit on the amount of permitted leverage. As you know this is the manner in which leverage is presently dealt with under NI 81-104.

As we note above, there are no limitations on the aggregate notional exposure under specified derivative transactions under the current regime applicable to commodity pools. Similarly, there are existing closed-end funds that have strategies that do not comply with the proposed 50% combined borrowing and short sale restrictions. As the investment objectives and strategies of any existing funds were established to comply with the current regime, we recommend that existing commodity pools and closed-end funds be grandfathered in and permitted to continue to operate under an exemption from any leverage limits (if any are adopted) subject to complying with the other requirements applicable to alternative funds and non-redeemable investment funds (as the case may be) under NI 81-102. We submit that, in many cases, to require existing commodity pools and closed-end funds to reduce the level of leverage used will result in the investment strategies used by the fund becoming wholly ineffective and may require such funds to cease operations.

There are generally recognized industry standards in Canada, the U.S. and other jurisdictions to determine the notional amount of exposure under a specified derivative that are used by investment fund managers for risk management, reporting and other purposes. In particular, we recommend that the proposed amendments include a carve-out provision that would permit an alternative fund, in determining the aggregate gross exposure, to net any directly offsetting specified derivatives transactions that are the same type of instrument and have the same underlying reference asset, maturity and other material terms. This carve-out would apply to specified derivatives transactions for which an alternative fund would use an offsetting transaction to effectively settle all or a portion of the transaction prior to expiration or maturity, such as certain futures and forward transactions. We believe that the approach adopted under the proposed amendments would allow alternative funds to use these industry standard calculation methods for the purposes of calculating the fund's exposure under the proposed amendments. As set out in the proposed Companion Policy amendments, this preferred approach will permit alternative funds to apply the same methodology consistently when calculating their aggregate gross exposure as well as calculating their NAV.

12. Section 6.8.1

Section 6.8.1 of NI 81-102 currently permits a fund to deposit up to 10% of NAV with a borrowing agent, other than its custodian or sub-custodian, as security in connection with a short sale (the "10% of NAV Limit"). In practice, a borrowing agent generally requires that the proceeds from the short sale, plus additional collateral be held as security. Under the current NI 81-102 aggregate short sale restriction of 20% of a fund's NAV, this practice results in the need for at up to two or three dealers/borrowing agents to facilitate and permit a fund to short the maximum 20% of its NAV.

However, given that the proposed amendments will permit an alternative fund to short up to 50% of its NAV, changes in the custodial provisions set out in Section 6.8.1 are necessary to alleviate both practical and operational issues for alternative funds. For example, under margin rules established by IIROC, an alternative fund entering into a short sale transaction for an equity security eligible for reduced margin would be required to post 130% of the market value of the short position as margin (security). As a result, an alternative fund that wishes to take full advantage of the increased short sale limits (50% of NAV) would be required to deal with 7 separate borrowing agents (other than the custodian) in order to comply with the 10% of NAV Limit in section 6.8.1. A similar situation would be experienced for other asset classes such as fixed income and FX forward transactions. This would not be practically feasible and would lead to operational and administrative inefficiencies and significantly increased costs for alternative funds.

We submit that a 20% of NAV deposit limit with borrowing agents (other than the fund's custodian or sub-custodian) as security for short sales by alternative funds would provide alternative funds with the flexibility to engage the services of two or more prime brokers (other than their custodian or sub-custodian) in an effort to execute their investment strategies in a more efficient manner and to help alleviate potential counterparty risk.

13. Parts 9 and 10

There is a need for Parts 9 and 10 to recognize that many alternative funds will allow purchases and redemptions on a weekly or monthly basis (that is, at the NAV of the Fund determined on the last day of a calendar week or month, for instance, provided the purchase order is received in advance of that applicable day). We point out that section 14.2(3) of National Instrument 81-106 Investment Fund Continuous Disclosure (NI 81-106) allows for weekly NAV calculations, but <u>requires</u> investment funds that use specified derivatives or engage in short sales to calculate NAV daily. Under the rules in Parts 9 and 10 of NI 81-102, the purchase or redemption price of a mutual fund security must be the next NAV determined after receipt of the applicable order. If a mutual fund is required to calculate NAV daily (as would be the case for many alternative funds), this would create difficulties for funds redeemable on a weekly or monthly basis. We do not consider that new subsection 10.3(5) provides sufficient flexibility in this regard (this provision is intended to allow for additional – and different flexibility regarding payment out of redemption proceeds) and note that there is no such flexibility provided for in Part 9 (dealing with purchases).

We believe there is a simple drafting fix for both Parts 9 and 10:

> Despite subsection [insert the correct section reference] an alternative fund may implement a policy that a person or company making a purchase/redemption order for securities of the alternative fund will receive the net asset value for those securities determined, as provided in the policy, on the **<u>next purchase/redemption date of the alternative fund</u>** ~~**first or 2nd business day**~~ after the date of receipt by the alternative fund of the purchase/redemption order.

We suggest that the CSA consider linking the weekly/daily NAV calculation requirements in NI 81-106 to the Companion Policy discussion about purchases and redemption orders and NAV for those purposes in NI 81-102.

14. Part 15

Section 15.6(1)(a) contains a prohibition against the inclusion of performance data in a sales communication for a mutual fund that has been distributing securities under a prospectus for less than 12 consecutive months.

Accordingly, an investment fund manager of an existing privately offered mutual fund (a pooled fund) with a suitable strategy that wanted to convert the pooled fund into a publicly offered alternative fund by filing a prospectus would not be able to include the historical track record of the pooled fund in sales communications pertaining to the alternative fund.

Given the unique nature of the proposed alternative fund changes, we strongly recommend that the CSA consider providing a limited exemption from the prohibition contained in Section 15.6(1)(a) of NI 81-102 to permit alternative funds that convert from a pooled fund to include their historical performance data in their sales communication with the appropriate qualifications, particularly in the situation where the pooled fund complied with the new NI 81-102 regime in all material respects. Without this information, investors will not be able to obtain a full picture of the skill and abilities of the investment fund manager in carrying out the strategies of the specific fund. We consider this important information for investors and believe that appropriate caveats can be provided, that would allow investors to properly understand this information.

Comments on Fund Facts/Prospectus Disclosure – NI 81-101 and NI 41-101 Amendments

15. Under the proposed amendments, alternative funds will be required to include specified “text box” disclosure in Fund Facts or on the prospectus face page (as applicable) that, among other things, will require an explanation about the “specific strategies that differentiate this fund from conventional mutual funds” and “how the listed investment strategies may affect an investor’s chance of losing money on their investment in the fund”. We feel this text box disclosure is not necessary and could likely require lengthy explanations which will be at odds with the regulatory purpose of the Fund Facts/face page disclosure.

We strongly recommend that the only relevant information (which may not even be that relevant given the other disclosure that will be in the Fund Facts or the long form prospectus), is a simple statement that “this mutual fund is an alternative fund. It has the ability to invest in asset classes or use investment strategies that are not permitted for conventional mutual funds. Please read the details of this fund’s investment objectives and strategies carefully and ask your advisor for more information as to how this fund will help you achieve your investment goals”.

Anything else would be too long, duplicative and potentially meaningless for investors – particularly in a Fund Facts document or face page disclosure that is designed to be concise and simple.

We particularly take issue with the notion that alternative funds’ strategies may “affect investors’ chance of losing money on their investment in the alternative fund”. This type of dire warning was included in “commodity pool” prospectuses, but the effectiveness of this disclosure, when considered in the context of modern-day alternative funds and the Fund Facts/ prospectus disclosure is not appropriate. We note also that requiring this disclosure for alternative funds but not more generally to non-redeemable investment funds appears to suggest that somehow alternative funds will be more likely to “lose money”, whereas non-redeemable investment funds are not. Also, it suggests that alternative funds are inherently more risky than conventional funds or closed-end funds, when this is not necessarily the case. We do not consider this distinction to be appropriate.

Comments on Transition

16. The CSA propose that any new rules will come into effect three months after publication date for the final rules, and that a further six months be provided to allow existing funds to change their affairs so as to comply with the new rules. We are not entirely certain that the suggested transition of the CSA works or is really necessary.

(a) **Some form of "grandfathering" will be necessary for existing commodity pools and closed-end funds as we recommend in our comment 11.**

(b) Otherwise, since there are not many commodity pools in existence, we recommend that the CSA simply permit existing commodity pools to continue with their prospectuses and operations – and make all amendments to their strategies (as required) and disclosure at their next renewal date, so long as that date is not within the 3 month transition period. Some timing considerations by the CSA would be considered very useful for existing commodity pools (i.e. allowing them to operate under the "old" regime until their next renewal time). It is not optimal for funds to have to file amended documents (which would be completely different – i.e. moving from a "long form" prospectus to the NI 81-101 requirements) mid-year or before the next renewal.

(c) The above-noted transition should also apply to closed-end funds that already have a prospectus and are reporting issuers (assuming they are in continuous distribution).

(d) Commodity pools and closed-end funds that do not wish to comply with the new regime, should be given a sufficient period to continue their operations, so long as no new sales are permitted after the lapse of one year (for instance) after the effective date of the new rules, so as to allow for an orderly wind-down of their operations or taking these vehicles private.

(e) Any current "private" fund that wishes to become a public reporting issuer (alternative fund) should be required to comply with the new requirements (i.e. change their affairs to become compliant) and file a preliminary prospectus under NI 81-101, which they can do at any time after the rules become effective.

(f) If any publicly offered mutual fund wishes to become an "alternative" fund, it will be required to adopt different investment strategies (and potentially investment objectives), which may take some time to implement. It would be appropriate for those funds to file an amended and restated prospectus with full compliance with the new requirements, if they wish to become an "alternative fund" before their next renewal.

Comments on Risk Classification Challenges

We understand that there will be challenges for alternative funds to comply with the new risk classification rules that were published in final form on December 8, 2016 and urge the CSA to consult further with the industry on this point. It may be that these amendments to NI 81-102 should include revisions to the risk classification rules to allow alternative funds to be able to calculate and disclose risk.

We thank you for considering our comments. Please contact any of the undersigned if you would like additional information or wish us to elaborate on our comments. We, together with others at our firm who have considered the proposed amendments, would be very pleased to meet with you.

Yours very truly,

Rebecca Cowdery	Lynn McGrade	Carol Derk	Michael Burns
416-367.6340	416.367. 6115	416.367. 6181	416.367. 6091
rcowdery@blg.com	lmcgrade@blg.com	cderk@blg.com	Mburns@blg.com
	Donna Spagnolo	Kathryn Fuller	
	416.367.6236	416.367.6731	
	dspagnolo@blg.com	kfuller@blg.com	

Borden Ladner Gervais

CANADIAN REGULATORS UNVEIL DRAFT RULES TO PERMIT THE OFFERING OF ALTERNATIVE FUNDS TO RETAIL INVESTORS

The Canadian Securities Administrators (CSA) has ushered in a bold new era for Canadian investors in its final push to modernize the regulation of investment funds. On September 22, 2016, the CSA published proposed amendments to National Instrument 81-102 *Investment Funds* (NI 81-102), Companion Policy 81-102CP and related national instruments [available here] which, when adopted in final form, will permit alternative mutual funds to be offered to retail investors in Canada in much the same manner as conventional mutual funds are currently offered. With these rule amendments, the CSA are finalizing their investment fund modernization rule review project that was launched in 2010 and described in some detail in 2011[1].

The ultimate effect of the proposed amendments will be to bring conventional mutual funds, "alternative funds" and closed-end funds (non-redeemable investment funds) under the same regulatory umbrella, with much the same regulation, but with important and significant differences, especially as it applies to investment restrictions for each of these categories of funds.

The proposed amendments will provide managers with a promising opportunity to bring alternative fund strategies to retail investors and include some positive changes for conventional mutual funds, including exchange traded funds (ETFs), but may also present new challenges to some closed-end funds (non-redeemable investment funds), given the proposal to add new investment restrictions to these funds.

The comment period on the proposed amendments ends on December 22, 2016.

[1] Please see: *Canadian Regulators Propose to Modernize Investment Fund Regulation* Investment Management Bulletin Borden Ladner Gervais LLP June 2011 and *Moving Beyond Mutual Funds – New Proposed Regulations for Public Closed-end Funds and "Alternative" Funds* Investment Management Bulletin Borden Ladner Gervais LLP April 2013.

REVISED NI 81-102 INVESTMENT RESTRICTIONS – *AT A GLANCE*

Investment Restriction*	Alternative funds	Conventional mutual funds and ETFs (mutual funds)	Closed end funds (Non-redeemable investment funds)
****Proposed changes are indicated in bold italic type***			
Concentration Restriction	***20 percent of NAV, subject to carve-outs***	10 percent of NAV, subject to carve-outs	***20 percent of NAV, subject to carve-outs***
Control restriction	No more than 10 percent of votes / equity securities of an issuer		
Restrictions on types of investments	No investment in: • real property • mortgages other than guaranteed mortgages • loan syndications / participations if any responsibility for administering the loan	No investment in: • real property • mortgages other than guaranteed mortgages • ***commodities other than 10 percent in certain precious metals (waived for precious metals funds)*** • loan syndications / participations if any responsibility for administering the loan	***No investment in:*** • ***real property*** • ***mortgages other than guaranteed mortgages*** • ***loan syndications / participations if any responsibility for administering the loan***
Illiquid assets	10 percent of NAV at time of investment (hard cap of 15 percent)		***20 percent of NAV at time of investment (hard cap of 25 percent)***
Fund-of-fund investments	• ***100 percent in underlying alternative mutual funds, non-redeemable investment funds, conventional mutual funds and ETFs***	• ***10 percent in underlying alternative funds and non-redeemable investment funds*** • ***100 percent in underlying conventional mutual funds and ETFs***	• ***100 percent in underlying alternative funds*** • 100 percent in underlying non-redeemable investment funds, conventional mutual funds and ETFs
Borrowing	***Limited to 50 percent of NAV, subject to restrictions***	Limited to 5 percent of NAV, subject to restrictions	***Limited to 50 percent of NAV, subject to restrictions***
Short-selling	***Up to 50 percent of NAV, with single issuer limited to 10 percent of NAV; no cash cover required***	Up to 20 percent of NAV, with single issuer limited to 5 percent of NAV; 150 percent cash cover required in all cases	***Up to 50 percent of NAV, with single issuer limited to 10 percent of NAV; no cash cover required***
Total borrowing and short-selling	***Aggregate limit of 50 percent of NAV at all times***	N/A	***Aggregate limit of 50 percent of NAV at all times***
Derivatives for hedging and non-hedging purposes	• ***No designated rating requirements for the derivative or counterparty*** • ***Counterparty exposure limit of 10 percent of NAV for derivatives, other than for cleared specified derivatives***	• Designated rating requirements for the derivative or counterparty • Counterparty exposure limit of 10 percent of NAV	• ***No designated rating requirements for the derivative or counterparty*** • ***Counterparty exposure limit of 10 percent of NAV for derivatives, other than for cleared specified derivatives***
Derivatives for non-hedging purposes	Exempt	Cover required for specified derivatives transactions	Exempt
Leverage	***Cannot exceed 3x NAV***	Leverage prohibited	***Cannot exceed 3x NAV***
Securities lending, repurchase and reverse repurchase arrangements	Permitted, subject to conditions		

INVESTMENT RESTRICTIONS

The CSA propose to replace the term "commodity pool" with the term "alternative fund", which will be defined in NI 81-102 as "*a mutual fund that has adopted fundamental investment objectives that permit it to invest in asset classes or adopt investment strategies that are otherwise prohibited by NI 81-102*". National Instrument 81-104 *Commodity Pools*, which has long regulated so-called "commodity pools", would be repealed.

Under the proposed rule amendments, an alternative fund will generally not be subject to the same investment restrictions as conventional mutual funds, but will be subject to certain restrictions applicable to non-redeemable investment funds. The proposed rule amendments also effect some welcome changes to the investment restrictions as they apply to conventional mutual funds and some – perhaps – less welcome changes for non-redeemable investment funds.

Concentration Restrictions – Investment in the securities of any one issuer (either directly or through a specified derivative or index participation unit) will be limited to 20 percent of the alternative fund's net asset value (NAV), which compares to the 10 percent of NAV limit for conventional mutual funds. As with conventional mutual funds, the concentration limit will be based on the market value of the securities at the time of purchase. Non-redeemable investment funds, which currently are not subject to a concentration restriction under applicable securities regulations, will also be subject to the same 20 percent of NAV limit proposed for alternative funds.

Illiquid Assets – The permitted level of investment by alternative funds in illiquid assets is proposed to be the same as for conventional mutual funds – 10 percent of NAV at the time of purchase, with a hard cap of 15 percent of NAV. The proposed amendments would also introduce a new limit on investment in illiquid assets for non-redeemable investment funds of 20 percent of NAV at the time of purchase, with a hard cap of 25 percent of NAV. This proposal reflects the CSA's continued focus on liquidity management for funds and is indicative of the broader international regulatory focus in this area.

Permitted Borrowing – Alternative funds and non-redeemable investment funds will have enhanced borrowing capabilities under the proposed amendments. Alternative funds and non-redeemable investment funds will be permitted to borrow up to 50 percent of NAV, subject to the certain conditions, including

- lenders must be entities that would qualify as an "investment fund custodian" under NI 81-102 (i.e. banks and trust companies in Canada, or their dealer affiliates)
- the fund's independent review committee (IRC) must approve any borrowing where the lender is an affiliate of the fund's investment fund manager
- any borrowing agreements entered into must be in accordance with normal industry practice and must be on standard commercial terms.

Permitted Short-Selling – Alternative funds and non-redeemable investment funds will be permitted to engage in short-sales of securities up to a limit of 50 percent of NAV, with the maximum amount of securities of a single issuer (measured by aggregate market value) that may be sold short being limited to 10 percent of NAV. The CSA also proposes to exempt alternative funds and non-redeemable investment funds from the requirement to hold cash cover and from the prohibition on the use of short-sale proceeds to purchase securities other than securities that qualify as cash cover. Conventional mutual funds will remain subject to the existing limits on short-sales.

Aggregate Borrowing and Short-Selling Limit – As cash borrowing and shorting may each be considered to be a form of leverage, the proposed amendments provide for an overall limit on the use of cash borrowing and short-selling by alternative funds and non-redeemable investment funds of 50 percent of NAV.

Use of Derivatives – The proposed amendments seek to codify exemptions routinely granted to investment funds from the counterparty designated ratings and exposure limits, which are necessary as a result of the *Dodd-Frank Wall Street Reform and Consumer Protection Act* in the United States, by permitting investment funds to engage in "cleared specified derivative" transactions, which would refer to any specified derivative cleared through a "specified clearing corporation". Further, the CSA proposes to amend the custodian requirements to permit an investment fund to deposit assets with a dealer as margin in respect of cleared specified derivatives.

Alternative funds will be permitted to enter into cleared specified derivative transactions in which the derivative counterparty and/or guarantor of the counterparty does not have a "designated rating". Alternative funds would also be permitted to enter into cleared specified derivative transactions without being subject to the 10 percent counterparty exposure limit, but would be subject to the 10 percent counterparty exposure limit for other types of derivatives. Non-redeemable investment funds would continue to be exempt from the counterparty designated rating requirement but would now be subject to the 10 percent counterparty exposure limit for derivative transactions that are not "cleared specified derivatives".

Alternative funds and non-redeemable investment funds would be exempt from the cover requirements to allow the use of derivatives to create synthetic leveraged exposure, subject to the overall limits on leverage discussed below.

Aggregate Leverage Limit – Alternative funds and non-redeemable investment funds will be permitted to use leverage through cash borrowing, short-selling and specified derivative transactions. The CSA proposes that the aggregate gross leverage exposure of an alternative fund or a non-redeemable investment fund, through any combination of these techniques, must be limited to three times (3x) NAV at all times, calculated as the sum of total amount of outstanding cash borrowed, combined market value of securities sold short and the aggregate notional amount of all specified derivative positions (including those used for hedging purposes) divided by the fund's net assets. Fund managers would be required to monitor each fund's total leverage on a daily basis. The CSA are asking for comments on the leverage calculation methodology and specifically whether derivatives exposure should be calculated on a notional basis and exclude derivatives positions used for hedging purposes.

Investments in Other Investment Funds (Fund-of-Fund Structures) – The proposed amendments seek to facilitate fund-of-fund structures by easing restrictions applicable to conventional mutual funds and alternative funds, although they make no changes to the fund-of-fund investing restrictions applicable to non-redeemable investment funds (which were more liberal than for mutual funds). Conventional mutual funds will be permitted to invest up to 10 percent of NAV in securities of alternative funds and non-redeemable investment funds, as well as continuing to be able to invest up to 100 percent of NAV in any other conventional mutual fund, provided that the underlying fund is subject to NI 81-102. The amendment proposes to remove the requirement that a conventional mutual fund may invest only in an underlying fund that files a simplified prospectus and codifies existing exemptions granted that permit conventional mutual funds to invest in ETFs. Similarly, under the proposed amendments, alternative funds may invest up to 100 percent of NAV in any other non-redeemable investment fund or mutual fund (including other alternative funds) provided that such underlying funds are subject to NI 81-102. Non-redeemable investment funds may continue to invest up to 100 percent of NAV in other investment funds.

The CSA also propose to remove the restriction providing that a conventional mutual fund may only invest in another investment fund that is a reporting issuer in the same "local jurisdiction", with the caveat that the underlying investment fund must be a reporting issuer in at least one Canadian jurisdiction.

Investment funds will remain prohibited from investing in non-prospectus qualified funds (pooled funds) and additionally, conventional mutual funds will remain unable to invest in active ETFs (i.e. funds that are not index participation units), absent an exemption.

Investment in Physical Commodities – The CSA propose to expand the scope of permitted investments in physical commodities for conventional mutual funds. Currently, conventional mutual funds may invest in gold (including "permitted gold certificates"), but may not invest in other physical commodities. The scope of permitted investments in the amended NI 81-102 would be expanded to codify exemptions that have been granted to allow conventional mutual funds to invest directly in silver, palladium and platinum in addition to gold (including certificates representing these precious metals) and to allow conventional mutual funds to obtain indirect exposure to any physical commodity through specified derivatives. Investments in physical commodities are still subject to a limit of 10 percent of a conventional mutual fund's NAV, which includes any investments in these commodities made by an underlying fund. The proposed amendment also codifies existing exemptions granted to precious metals funds to allow them to continue to invest more than 10 percent of NAV in permitted precious metals. Neither alternative funds nor non-redeemable investment funds are subject to this prohibition on investing in commodities.

DISCLOSURE, SET UP COSTS AND MARKETING OF ALTERNATIVE FUNDS

Offering Documents – Alternative funds that are not listed on an exchange will be subject to the same disclosure regime as conventional mutual funds under NI 81-101, meaning that the alternative fund will be required to prepare a simplified prospectus (SP), an annual information form (AIF) and fund facts document for each series or class of securities of the fund. The SP and fund facts will be required to include face page disclosure which identifies the fund as an alternative fund and text box disclosure which describes how the investment strategies and asset classes to be utilized by the alternative fund differ from conventional mutual funds, and any attendant risks associated with such strategies or asset classes.

All other types of investment funds (including exchange-listed alternative funds, ETFs and non-redeemable investment funds) must continue to file a long form prospectus under NI 41-101. The June 2015 proposals to implement an ETF Facts disclosure document for ETFs remains to be finalized[2].

The SP for an alternative fund will not be permitted to be consolidated with the SP for a conventional mutual fund under the proposed amendments.

Seed Capital Requirements and Responsibility for Organizational Costs – Seed capital requirements for new alternative funds would be set at the same level as for conventional mutual funds - $150,000 - and a manager would be permitted to redeem its seed capital investment once the fund has raised a minimum of $500,000 from outside investors.

Alternative funds will be subject to the same prohibition against reimbursement of organizational costs (including costs of incorporation, formation, organization as well as the costs of the preparation and filing of any of the preliminary prospectus, preliminary annual information form, preliminary fund facts, initial SP, AIF or fund facts) as conventional mutual funds. Managers of non-redeemable investment funds and exchange traded funds which are not in continuous distribution will continue to be able to pass organizational costs onto these funds.

Marketing of Prior Performance – Alternative fund managers with existing privately offered funds should be aware that the marketing rules in NI 81-102 will prohibit the linking of the performance of their existing alternative fund strategies with that of an alternative fund offered under a prospectus. Even if the existing private fund is "converted" into a NI 81-102 compliant fund, marketing of performance of the fund prior to the date of the final prospectus receipt will be prohibited.

DISTRIBUTION OF ALTERNATIVE FUNDS

The proposed amendments will not incorporate the proficiency requirements currently applicable to distributors of commodity pools under NI 81-104. Instead, proficiency requirements for the distribution of alternative funds will be addressed through the existing "know your client", "know your product" and suitability obligations of registered dealers. The CSA have acknowledged that additional education, training and experience requirements may be required for representatives of mutual fund dealers (and members of the MFDA) in order to fully understand the unique features and strategies that alternative funds may employ. As a result, the CSA explains that they intend to work with the MFDA to determine the appropriate requirements for mutual fund dealing representatives that seek to trade in securities of alternative funds.

OTHER REQUIREMENTS APPLICABLE TO ALTERNATIVE FUNDS

Alternative funds also will be subject to other requirements applicable to conventional mutual funds.

Independent Review Committee Requirement – Managers of alternative funds will be required to appoint an independent review committee (IRC) under National Instrument 81-107 *Independent Review Committee for Investment Funds* (NI 81-107). In addition to the other requirements of NI 81-107, the IRC will be required to review and approve any transaction in which the fund proposes to borrow cash from an affiliate of the investment fund manager, as described above.

Continuous Disclosure Requirements – Alternative funds will be subject to the continuous disclosure obligations contained in National Instrument 81-106 *Investment Fund Continuous Disclosure* and any investment fund that uses leverage must include disclosure about its use of leverage in the fund's interim financial reports, annual financial statements and management report of fund performance.

Compliance with Mutual Fund Sales Practices Requirements – As alternative funds will be "mutual funds", it is expected that they will be subject to National Instrument 81-105 *Mutual Fund Sales Practices*, which imposes restrictions on certain sales and compensation practices.

PROPOSED TRANSITION

If approved, the proposed amendments would come into force approximately three months after their final publication date and would immediately apply to any new investment fund that files a preliminary or final prospectus after that date. For existing funds, the proposed amendments would become applicable after an additional six months following the coming into force date of the amendments, which we interpret as nine months following the final publication date.

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[2] See *Marrying the Rules for ETFs and Mutual Funds? Canadian Securities Administrators Propose New "ETF Facts" to be Delivered to Investors Post-Trade* Investment Management Bulletin Borden Ladner Gervais LLP June 2015.

POTENTIAL IMPLICATIONS OF THE PROPOSED AMENDMENTS

ALTERNATIVE FUNDS

The publication of the proposed amendments represents an opportunity for the managers of alternative funds to make these strategies, which were previously only offered to high net worth individuals and institutional investors in the private market, available to Canadian retail investors. This will allow managers of alternative funds to achieve a greater scale and flexibility to employ their strategies in an effective manner. At the same time, managers of alternative funds must be ready to accept a far greater level of regulation and fund governance requirements compared to the private investment fund market. Alternative fund managers must consider what adjustments they may need to make to the investment strategies they employ in order to comply with the restrictions contained in the proposed amendments and what, if any, impact such changes may have on the returns of such investment strategies.

We expect that any alternative fund manager contemplating offering funds to the public under the amended NI 81-102 would want to conduct a detailed review of its business plan filed in connection with its existing securities registrations, as well as its internal policies and procedures compliance manual, and to make any amendments or adopt additional policies and procedures as may be required in order for the manager to offer funds at a retail level in Canada.

CONVENTIONAL MUTUAL FUNDS

Conventional mutual funds will benefit from the codification of various exemptions from NI 81-102 contained in the proposed amendments, including the expanded scope of permitted investment in physical commodities, and relief from the counterparty designated ratings and exposure limits for derivatives cleared through a “specified clearing corporation”.

We expect that some conventional mutual funds will also welcome the opportunity to be able to invest up to 10 percent of NAV in underlying alternative funds and non-redeemable investment funds. This type of amendment is reflective of the CSA view that it is appropriate for retail investors to have some portion of their portfolio exposed to alternative strategies and is consistent with the main impetus to modernize the alternative funds regime for retail investors.

An existing conventional mutual fund that wishes to convert to being an alternative fund would be required to seek securityholder approval, as a change in investment objectives and strategies of this degree would no doubt be a fundamental change to the fund.

NON-REDEEMABLE INVESTMENT FUNDS

Non-redeemable investment funds will see benefit in the ability to obtain exposure to alternative funds through fund-of-fund investments. However, non-redeemable investment funds will be required to carefully review their current investment strategies and make modifications to their strategies and related compliance monitoring in order to adopt the new investment restrictions imposed by the amendments, including the 20 percent of NAV concentration limit, the introduction of restrictions on certain types of investments, the 20 percent limit on illiquid investments at the time of purchase (25 percent hard cap), the introduction of limits on borrowing, short-selling and the use of leverage and the inclusion of a counterparty exposure limit of 10 percent of NAV for derivative transactions.

In some cases, the CSA have signalled their willingness to consider whether the adoption of some of the proposed investment restrictions is also appropriate for non-redeemable investment funds.

INVESTORS

The Canadian retail investor will be the ultimate beneficiary of the proposed amendments, which will introduce a multitude of new and varied investment options that may be utilized to help achieve their investment goals. A crucial component of the proposed amendments is the “one-stop shopping” element of the proposals, which will enable investors to purchase conventional mutual funds and alternative funds under similar offering documents and through familiar distribution channels, which should facilitate comparisons between investment options and encourage both a smooth transition and rapid acceptance of the new rules.

COMMENTS ON THE PROPOSED RULE AMENDMENTS

It will be important to provide feedback to the CSA on their proposals, particularly on whether or not the proposals for investment restrictions are practical and workable – that is, will they permit a broad range of alternative investment strategies to be offered to the retail public that are currently available only to the high net worth or institutional marketplace. Comments are due by December 22, 2016. Please contact the authors of this Bulletin or your usual lawyer in BLG's Investment Management practice group if you would like any assistance in understanding the rule amendments and how they would apply to your business or in drafting your response letter to the CSA.

AUTHORS:

Michael Burns
416.367.6091
MBurns@blg.com

Kathryn Fuller
416.367.6731
KFuller@blg.com

Chelsea Papadatos
416.367.6594
CPapadatos@blg.com

INVESTMENT MANAGEMENT GROUP

National Leader

John E. Hall	Toronto	416.367.6643	JHall@blg.com

Regional Leaders

Jonathan L. Doll	Calgary	403.232.9659	JDoll@blg.com
Christian Faribault	Montréal	514.954.2501	CFaribault@blg.com
Lynn M. McGrade	Toronto	416.367.6115	LMcgrade@blg.com
Jason J. Brooks	Vancouver	604.640.4102	JBrooks@blg.com

Borden Ladner Gervais

BORDEN LADNER GERVAIS LLP
LAWYERS I PATENT & TRADEMARK AGENTS

Calgary
Centennial Place, East Tower
1900, 520 – 3rd Ave S W, Calgary, AB, Canada T2P 0R3
T 403.232.9500 I F 403.266.1395

Montréal
1000, De La Gauchetière St W, Suite 900
Montréal, QC, Canada H3B 5H4
T 514.879.1212 I F 514.954.1905

Ottawa
World Exchange Plaza, 100 Queen St, Suite 1300
Ottawa, ON, Canada K1P 1J9
T 613.237.5160 I F 613.230.8842 (Legal)
F 613.787.3558 (IP) I ipinfo@blg.com (IP)

Toronto
Bay Adelaide Centre, East Tower, 22 Adelaide St W.
Toronto, ON Canada M5H 4E3
T 416.367.6000 I F 416.367.6749

Vancouver
1200 Waterfront Centre, 200 Burrard St, P.O. Box 48600
Vancouver, BC, Canada V7X 1T2
T 604.687.5744 I F 604.687.1415

blg.com