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December 22, 2016

Delivered By Email: comments@osc.gov.on.ca; consultation-en-cours@lautorite.qc.ca

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

In care of

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

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

Dear Sirs/Mesdames:

Re: Canadian Securities Administrators ("CSA") Notice and Request for Comment - Modernization of Investment Fund Product Regulation – Alternative Funds (the "Proposed Amendments")

BMO Capital Markets ("**BMO CM**") and BMO Global Asset Management (which includes BMO Asset Management Inc. and BMO Investments Inc.) ("**BMO GAM**" and together with BMO CM, "**BMO**" or "**we**") appreciate the opportunity to provide comments on the Proposed Amendments and are generally supportive of the Proposed Amendments. Please note that our comments do not address non-redeemable investment funds. We believe that the proposals largely succeed in balancing retail investors' need for innovative investment solutions with risk management and investor protection concerns, subject to the following general comments below:

Definition of "Illiquid Asset" and Restrictions Concerning Illiquid Assets (Sections 1.1 and 2.4 of NI 81-102)

The Proposed Amendments specify a 10% limit for investments in illiquid assets by mutual funds at the time of purchase (with a 15% hard cap). We feel increasing the illiquid assets limit to 15% of net asset value at the time of purchase (with a 20% hard cap) for an alternative fund would be an appropriate balance between investor protection and fund manager flexibility to manage alternative strategies for performance. We note that this level of illiquid assets is in line with guidelines issued under the Investment Company Act of 1940 (the "**1940 Act**") in the U.S.

We also suggest that the definition of "illiquid asset" in National Instrument 81-102 - *Investment Funds* ("**NI 81-102**") be updated to explicitly exclude asset classes that are traded on over-the-counter ("**OTC**") markets and may be accurately priced on an arm's length basis. Many conventional asset classes, such as bonds, trade on OTC markets and the fact that a security is not quoted on a recognized marketplace does not indicate that the security is illiquid. We note that Securities and Exchange Commission (SEC) guidance considers an asset to be illiquid if it cannot be sold in current market conditions within seven calendar days without significantly changing the market value of the investment. It is our understanding that in the U.S., this determination is tested and verified by an investment fund's auditors and that this sort of market-based definition works well. We believe that a similar, market-based approach to the definition of illiquid asset under NI 81-102 would be appropriate.

Single Issuer Short Sale Limits Regarding Government Securities and Index Participation Units ("IPUs") (Section 2.6.1(c)(iv) of NI 81-102)

Section 2.1 of NI 81-102 provides exemptions to the concentration restrictions for long investments in IPUs, government securities and purchases of investment funds made in accordance with Section 2.5 of NI 81-102. We believe that a similar exemption should be integrated into the short selling restrictions in Section 2.6.1(c)(iv) of NI 81-102. This is important, among other things, to facilitate hedging of long investments permitted by the above exemptions.

Short Selling Restrictions (Section 2.6.1(c)(v) of NI 81-102)

We support the proposal for a 50% limit on short selling as set out in Section 2.6.1(c)(v) of NI 81-102 under the Proposed Amendments (the "**Short Sale Limit**") which coincides with 1940 Act limits.

However we suggest that the CSA exempt alternative funds that employ a market neutral strategy from the Short Sale Limit as it would impose a significant obstacle since such funds typically require up to 100% short positions. Although derivatives may be used to achieve similar results, it is our understanding that this may not be as cost-effective as a simple shorting of securities to pursue such a strategy. Funds that employ a market neutral strategy can be useful diversification tools for investors as they create different correlations and risk profiles than the market in general.

Counterparty Exposure Limits in Respect of Specified Derivatives (Section 2.7(4) of NI 81-102)

We suggest that the CSA maintain the counterparty exposure exemption for alternative funds as currently set out in NI 81-102.

The proposed 10% limit with any one counterparty for specified derivatives imposes significant operational constraints as existing commodity pools would be required to find at least ten different counterparties to maintain their existing specified derivatives exposure under the current rules. This proposed change would have significant operational and compliance implications for funds which engage in these transactions and would add significant transaction costs. Funds currently do not tend to enter into specified derivatives transactions with more than one or two counterparties at a time, because the administrative costs of negotiating each new transaction and the ongoing costs of dealing separately with multiple counterparties are significant. The administrative and operational costs to move from one or two counterparties to more than ten counterparties would have a material impact on the ability of funds to engage in these transactions. The Proposed Amendments would also require such funds to close out any position with a particular counterparty if such position exceeded the 10% limit. Monitoring and closing out these mark-to-market positions would impose significant compliance and operational burdens on funds.

We further suggest that the CSA amend section 2.7(5) of NI 81-102 to specify that the mark-to-market value calculation of the specified derivatives position with a counterparty will be net of any credit support provided by such counterparty where the investment fund has a legally enforceable pledge of collateral from the counterparty.

Total Leverage Limit (Section 2.9.1 of NI 81-102)

The Proposed Amendments set an overall limit on leverage by investment funds at three times the net asset value ("**NAV**") of an investment fund (the "**Total Leverage Limit**"). We are generally supportive of the Total Leverage Limit. However, we believe that the Total Leverage Limit, in its current draft form, may cause issues for fixed-income alternative funds that employ leverage to implement their investment objectives and for investment funds that engage in hedging transactions.

It is important to note that certain fixed-income strategies often use significant leverage, in excess of the Total Leverage Limit, to implement their investment objectives. Fixed-income assets are allowed high rates of margin leverage under the IIROC Rules, largely because fixed-income assets are viewed as being less volatile than equity and other investments. Equity funds that use less leverage may be riskier than fixed-income funds with the same leverage due to their underlying riskier assets. Therefore we believe that a separate higher leverage limit should be adopted for fixed-income funds. Further review of an appropriate leverage limit is warranted.

We are also of the view that alternative funds should be able to exclude hedging transactions (for example derivative transactions such as foreign exchange forwards or government bond futures) when calculating total leverage as contemplated under the Proposed Amendments, as such transactions are intended to decrease risk. We also propose that alternative funds be permitted 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 against investments hedged by such derivatives when determining an alternative fund's aggregate exposure. Accordingly, we believe that calculating notional amounts based on net exposures is the appropriate way to illustrate exposure to leverage to a retail investor.

Custodial Requirements for Alternative Funds (Part 6 of NI 81-102)

The Proposed Amendments may create significant issues in respect of the provision of prime brokerage services to alternative funds. Prime brokerage generally refers to a bundled package of services offered by investment dealers to investment funds which need the ability to borrow securities and cash in order to invest in accordance with their investment objectives. Prime brokers act as a financing counterparty by lending cash and securities to funds and they also provide a centralized account to enable custody, settlement and clearing of securities for funds. This activity requires prime brokers to take a security interest in the collateral held in such accounts and the assets of such accounts are subject to rehypothecation by the prime broker. The existing custodial requirements under NI 81-102, although not expressly prohibiting a prime broker from acting as custodian or sub-custodian to a publicly offered investment fund, contain requirements which make it practically and/or commercially unfeasible for prime brokers to act in a dual capacity.

In particular:

- Subject to certain exceptions, Section 6.4(3)(a) of NI 81-102 generally prohibits the creation of any security interest on the portfolio assets of an investment fund in a custodial or sub-custodial agreement.

- Section 6.4(3)(b) of NI 81-102 prohibits custodial or sub-custodial agreements from requiring payment of fees to a custodian or a sub-custodian for the transfer of the beneficial ownership of portfolio assets of the investment fund. One of the principal aspects of a prime brokerage agreement is the payment of fees to the prime broker in connection with the trading activities of the investment fund (i.e. the change of beneficial ownership of securities).

- Section 6.5 of NI 81-102, particularly the segregation requirements for portfolio assets which are in bearer form, may pose a significant impediment to the ability of a prime broker to also act as custodian or sub-custodian of an alternative fund because the segregation of portfolio assets in a prime brokerage agreement and as permitted under applicable IIROC Rules will typically permit these assets to be comingled with the assets of other clients of the prime broker, which is essential for the rehypothecation of such assets.

We suggest that the CSA permit registered investment dealers that are members of IIROC to act as a Canadian custodian or sub-custodian of publicly offered alternative funds ("**IIROC Custodian**") by:

- Exempting custodial/sub-custodial agreements with IIROC Custodians from the portions of Section 6.4(3) of NI 81-102 that relate to the taking of security and payment of fees.

- Exempting custodial/sub-custodial agreements from the portions of Section 6.5 of NI 81-102 that relate to the holding/segregation of portfolio assets and permit IIROC Custodians to segregate client assets in accordance with IIROC Rules 17.3 and 17.3A – *Dealer Member Minimum Capital, Conduct of Business and Insurance* and Rule 2000 – *Segregation Requirements*.

In our view, use of IIROC Custodians by alternative funds would not disadvantage retail investors because:

- IIROC Rules 17.3 and 17.3A – *Dealer Member Minimum Capital, Conduct of Business and Insurance* and Rule 2000 – *Segregation Requirements* specifically require segregation of fully-paid-for securities;
- Financial requirements as set out in NI 81-102 mean that only dealers that can demonstrate significant financial resources can act as IIROC Custodians; and
- IIROC dealers have comparable investor protection mechanisms to those of other custodians.

In addition, there could be potential additional material operational and administrative costs for alternative funds if they are not permitted to have one or more prime brokers act as the custodian or sub-custodian of the portfolio assets of the fund. In particular, if rehypothecation of portfolio assets is not possible, custodial costs borne by an alternative fund would be significantly higher.

Custodial Provisions Relating to Short Sales (Section 6.8.1 of NI 81-102)

We believe that Section 6.8.1 of NI 81-102 should be revised to permit a fund to deposit 20% (as opposed to 10% as currently proposed) of NAV with a borrowing agent (other than the fund's custodian or sub-custodian) as security in connection with a short sale (the "**10% Deposit Limit**").

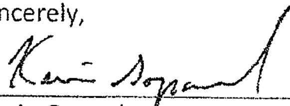
Under the Proposed Amendments, an alternative fund will be able to short up to 50% of its NAV (as compared to the current 20% NAV short sale limit). Increasing the short sale limit from 20% to 50% without changing the 10% Deposit Limit will have the unintended consequence of increasing operational and administrational burdens as the alternative fund could be required to deal with up to seven different borrowing agents (as opposed to 2 or 3 borrowing agents under the current rules).

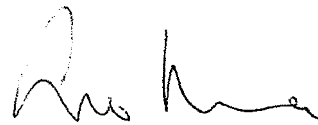
Disclosure

We urge the CSA to be consistent in the disclosure rules for all types of alternative funds and to abandon any comparisons between a "conventional" mutual fund and an alternative fund in the relevant disclosure documents. Rather, disclosure should focus on the specific features that are unique to the particular alternative fund, including, for example, investment strategies detailing specific derivative instruments, to enable investors to better understand the risks associated with their investment.

If you have any questions or comments regarding any aspect of this letter, please do not hesitate to contact any of the undersigned.

Sincerely,





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