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December 22, 2016

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

Attention:

The Secretary
Ontario Securities Commission
20 Queen Street West
22nd Floor
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 and Mesdames:

RE: CSA Notice and Request for Comment—Modernization of Investment Fund Product Regulation—Alternative Funds

We are writing in response to the CSA Notice and Request for Comment published on September 22, 2016 (the "**Notice**") concerning proposed amendments (the "**Proposed Amendments**") that include a comprehensive framework for the regulation of "alternative funds" (the "**Alternative Funds Proposal**") under National Instrument 81-102 Investment Funds ("**NI 81-102**").

We are writing following consultation with a number of participants in the non-redeemable investment fund ("**NRIF**") industry. These comments do not necessarily represent the views of the members of our respective firms or our clients.

Our comments below are divided into two Parts. In Part I we address certain of the specific questions of the CSA relating to the Proposed Amendments, including certain proposed investment restrictions for NRIFs that the CSA considered to be interrelated with the Alternative Funds Proposal regarding investments in physical commodities, borrowing cash, short selling and use of derivatives defined as the "**Interrelated Investment Restrictions**".

In Part II we provide some additional comments on the Proposed Amendments and NI 81-102, generally.

Part I **Specific CSA Questions**

Question 1—Definition of "Alternative Fund"

We support the use of the term "alternative fund", but it is not apparent to us why the CSA felt the need to define an alternative fund as a type of mutual fund or to integrate alternative funds into NI 81-102. After nearly three years of development, this feels like an opportunity missed to develop a truly alternative funds framework.

Question 3—Concentration

We do not believe that an upper limit or hard cap on concentration is required for an alternative fund or a NRIF as we believe that concentration and liquidity are separate issues. See our comments on liquidity in the following response. We submit that some investors may find concentrated positions more appealing in an alternative fund or a NRIF, as they often focus on diversification across their portfolio rather than within products they hold in their portfolio.

Questions 5 & 7—Illiquid Assets/Redemptions

We reiterate our view that restrictions on concentration and illiquid assets are not required for alternative funds and NRIFs that are not redeemable, infrequently redeemable or exchange listed such that investors do not rely solely on redemption rights for liquidity. The linkage between a fund's liquidity requirements and the right to redeem units/shares is widely recognized. For example, in its 2013 report *Principles of Liquidity Risk Management for Collective Investment Schemes*, IOSCO recommended 15 principles including that "The responsible entity should set appropriate liquidity thresholds which are proportionate to the redemption obligations and liabilities of the [collective investment scheme]". The report states, "For example, a daily dealing CIS would be expected to have stricter liquidity requirements than a CIS sold on the basis that investors would not be expected to redeem before a set period expired."

It follows that a fund with less frequent redemptions would be expected to have less strict liquidity requirements.

Imposing liquidity requirements on funds that do not match a fund's terms and conditions and investor expectations, we submit, may impose unwarranted costs on investors including restrictions that limit innovation and differentiation. We also do not believe that securities regulators should seek to impose portfolio restrictions for other reasons such as "safety" or capital preservation which is better left to portfolio managers to assess and manage in the context of other products in the market.

Question 6—Illiquid Assets/Investment Cap

We do not believe that a cap on illiquid assets is required for alternative funds and NRIFs. Some investors may want access to less liquid assets classes potentially offered by alternative funds or NRIFs and the Proposed Amendments would limit such access.

Question 8—Borrowing

We do not agree with the proposal to restrict alternative funds and NRIFs to borrowing from entities that would qualify as an investment fund custodian under section 6.2 of NI 81-102, which essentially restricts borrowing to banks and trust companies in Canada (or their dealer affiliates). Since an alternative fund or a NRIF is not exposed to the credit risk of a lender, we do not see the policy rationale for excluding lending to investment funds by (i) foreign lenders and (ii) Canadian lenders that are not financial institutions. In our view, this restriction unnecessarily limits market options and may contribute to higher borrowing costs being borne by investors.

We agree with the proposals for independent review committee approval where the lender is an affiliate of the investment fund's investment fund manager and that loan agreements should be in accordance with normal industry practice and on standard commercial terms. We submit that these proposals, together with existing restrictions on lending under Section 13.12 of NI 31-103, are sufficient counterparty restrictions.

At a minimum, to facilitate lending by foreign lenders, we submit that alternative funds and NRIFs should be permitted to borrow from entities described in Section 6.3 as well as Section 6.2 of NI 81-102.

Finally, for consistency, the requirement in Section 6.2(3)(a) that financial statements must "have been made public" should be removed. This requirement (i) does not apply to an entity under Section 6.3 of NI 81-102 and (ii) has been removed from the definition of "Canadian custodian" under proposed amendments to National Instrument 31-103 *Registration Requirements, Exemptions and Ongoing Registrant Obligations*, published for comment on July 7, 2016. This approach would codify exemptive relief granted to bank-owned affiliates from the public disclosure requirement under Section 6.2(3)(a) of NI 81-102 in the past.

Questions 9, 10 & 11—Total Leverage Limit

We do not agree with using the gross notional amount of specified derivatives as a portfolio leverage limit in a manner that does not take into account the actual amount of market risk exposure in any individual position or the amount of risk exposure of the portfolio. As you are no doubt aware, the SEC adopted this "blunt instrument" approach in proposed rule 18f-4 under the *Investment Company Act of 1940*, as amended, regarding the use of derivatives and certain related instruments by registered investment companies (the "**SEC Proposal**").[1]

Proposed rule 18f-4 limits the amount of leverage a fund may obtain through derivatives or certain other senior securities transactions, by requiring that a fund comply with a new requirement to limit a fund's aggregate exposure using one of two alternatives. The first alternative imposes a gross notional exposure limit of 150 percent of a fund's net assets. The second alternative imposes a risk-based gross notional limit of 300 percent of a fund's net assets for those funds where the derivatives transactions, in aggregate, result in an investment portfolio that is subject to less market risk than if the fund did not use such derivatives.[2]

We believe that any leverage definition for specified derivative exposure should include netting of risk-mitigating instruments. We agree that the CSA should allow a fund to include offsetting or hedging transactions to reduce its calculated leveraged exposure.

Netting is permitted under both proposed rule 18f-4 and in guidelines of the Committee of European Securities Regulators for funds subject to the European Union's Undertakings for Collective Investment in Transferable Securities ("**UCITS**") directive. However, we submit, both of these approaches are unduly complex and overly restrictive.

These approaches and alternatives have been exhaustively canvassed in the SEC Proposal and the more than 175 comment letters and papers that the SEC received in response to the SEC Proposal.[3] We refer you to two in particular:

(i) White Paper by James A. Overdahl, Ph.D. Delta Strategy Group, *Proposed Rule 18f-4 on the Use of Derivative Instruments by Registered Investment Companies* dated March 24, 2016;[4] and

[1] See "Use of Derivatives by Registered Investment Companies and Business Development Companies," Release
No. IC-31933 (Dec. 11, 2015), available at: http://www.sec.gov/rules/proposed/2015/ic-31933.pdf.
[2] White Paper by James A. Overdahl, Ph.D. Delta Strategy Group, Proposed Rule 18f-4 on the Use of Derivative Instruments by Registered Investment Companies dated March 24, 2016 at page 7.
[3] *The Investment Lawyer*, Vol. 23, No. 6, June 2016. Available at:
https://www.dechert.com/files/Uploads/Documents/FSG/IL_0616_Hinkle_Kerfoot_Dreyfuss.pdf

(ii) Letter from Timothy W. Cameron, Esq., Asset Management Group–Head, Securities Industry and Financial Markets Association, to Brent J. Fields, Secretary, Securities and Exchange Commission, dated March 28, 2016.[5]

Rather than being overly prescriptive, we encourage the OSC to continue the principles based approach in NI 81-102 and exclude from the exposure limit calculation any exposure associated with derivatives transactions that may be used to hedge or cover other transactions. Many transactions such as currency hedging and offsetting positions under equity swaps are easily identified and widely accepted as transactions that do not increase portfolio leverage but rather reduce market risk.

Question 12—*Interrelated Investment Restrictions*

Our comments on borrowing cash and use of derivatives are set out above.

Physical Commodities—We agree that NRIF should be exempt from the provisions in Section 2.3 of NI 81-102 governing investment in physical commodities.

Short Selling—We do not agree with a restriction on short selling for alternative funds and NRIFs. We have a similar concern with a restriction on short selling as we expressed above in respect of the proposed concentration and illiquid asset restrictions. Capping short sales without consideration of a fund's terms and conditions and investor expectations, we submit, may impose the same unwarranted costs on investors noted above. Investors will bear the cost of portfolio liquidity that they neither need nor expect.

We also note that the Proposed Amendments have an implicit bias to the use of specified derivatives. The leverage cap for short sales is 50% of NAV. However, the leverage cap for specified derivatives is 3 times NAV. But funds can use specified derivatives (i.e. equity swaps) to take a short position rather than entering into a physical short.

Question 15—Point of Sale

Mutual funds, ETFs and listed alternative funds will all be able to transact on a summary point of sale document. We do not see the policy rationale to restrict NRIFs and unlisted alternative funds from also using a point of sale document. This proposal seems inconsistent with the CSA's efforts to harmonize disclosure regimes.

Question 16—Transition

We reiterate our submission that all existing NRIFs and commodity pools should be grandfathered from the Interrelated Investment Restrictions. Existing NRIFs should continue to be able to conduct their business, operations and affairs in all respects in compliance with their constating or governing documents. In particular, they should continue to be able to issue securities. We believe that if investors or their advisors wish to move to products governed by the new NI 81-102 regime, they have the choice to sell or redeem their units/shares of grandfathered funds and purchase new products.

Requiring a transition period for NRIFs is inappropriate as it would create substantial confusion and uncertainty for investors since it is unclear how the transition would impact the relevant fund in terms of costs and ability to continue and possibly compromise their ability to report historical performance. Furthermore, and more importantly, investment fund managers created and marketed these funds and investors purchased these funds on the basis of their current structure and it is not clear why this agreement should be abrogated. It is important that the CSA provide clarity regarding grandfathering as

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[4] Available at: https://www.google.ca/search?q=SEC+derivativex+blunt+instrument&oq=SEC+derivativex+blunt+instrument&aqs=chrome..69i57.11843j0j4&sourceid=chrome&ie=UTF-8.

[5] Available at: http://www.sifma.org/issues/item.aspx?id=8589959548.

soon as possible as we have concerns that the prevailing uncertainty may have a chilling effect on the NRIF market and we do not believe that this is what the CSA intended by the Notice.

Part II **Other Comments**

(a) Definition of Illiquid Assets

As we stated in our Previous Comment Letter, we believe the definition of "illiquid asset" must be updated before it is extended to other fund types.

In particular, the CSA needs to clarify that asset classes such as OTC derivatives, syndicated loans, corporate bonds and emerging-market sovereign and quasi-sovereign bonds that trade primarily over-the-counter are not illiquid assets. Although these institutional markets have no public quotations in common use that are widely available to retail investors, they are nonetheless very liquid markets.

Alternatively, we would support the US approach under Rule 22e-4 adopted by the United States Securities and Exchange Commission on October 13, 2016.[6] Under Rule 22e-4, an illiquid investment is an investment that the fund reasonably expects cannot be sold in current market conditions in seven calendar days without significantly changing the market value of the investment.

(b) Counterparty Requirements

We do not support the removal of the exemption for alternative funds and NRIFs from the exposure limits under section 2.7(4) and section 2.7(5) of NI 81-102, or the addition of section 2.1(1.1) of NI 81-102 as it applies to prepaid specified derivatives. A prepaid specified derivative means that, upon entering into the transaction, the investment fund pays all of its obligations up front and therefore has no further obligations under the transaction. These types of transactions are beneficial to investment funds.

In fact, we would support an exemption for any investment fund from section 2.1, section 2.4, section 2.7(4) and section 2.7(5) of NI 81-102 (the "**Applicable Sections**") with respect to a prepaid specified derivative transaction, as long as (i) the investment fund's counterparty has a designated rating at all times, and (ii) the counterparty's obligations under the prepaid specified derivative transaction are fully collateralized. For this purpose, the term "fully collateralized" means that the collateral held by the investment fund plus the prepaid specified derivative is marked-to-market on a weekly basis and the amount of collateral will be adjusted each week to ensure that the market value of the collateral held by the investment fund, when adjusted, will be equal to the mark-to-market value of the corresponding prepaid specified derivative. We submit that, as long as those two conditions are met, the investment fund is fully protected and should not be prevented from entering into a prepaid specified derivative which would otherwise contravene the Applicable Sections.

(c) Alternative Fund/Redemptions

We think that an alternative fund should have the flexibility to be either a mutual fund or a NRIF. Practically, in order to be listed, an alternative fund could not be redeemable on demand. Such a fund would be able to adopt the redemption feature of a NRIF with an annual redemption at NAV. We also think that an unlisted alternative fund should be able to adopt a redemption frequency of its choosing such as monthly, quarterly or semi-annually.

(d) Transforming NRIFs into Mutual Funds Carries a Cost

In the Notice, the CSA concluded that "Not proceeding with the Proposed Amendments in respect of the Interrelated Investment Restrictions would not be appropriate in view of both investor protection and fairness concerns, since this would permit some NRIFs to potentially operate in a manner that is inconsistent with other investment funds."

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[6] Available at: https://www.sec.gov/rules/final/2016/33-10233.pdf.

And yet no evidence is offered as a basis to support this view. Fairness to whom? Investors that will necessarily have their choice of investment products reduced? Managers whose products are being limited on the basis of investor protection where no evidence of investor loss is provided? Operating in a manner inconsistent with other investment funds is precisely why NRIFs exist. To try to transform NRIFs into listed mutual fund-like products is to regulate so as to create a product that does not exist today and for which there is no evidence of investor need, expectation or, for that matter, appetite.

While many market participants supported the “Core Operational Requirements” introduced in 2013, they also questioned the rationale for the CSA proceeding with the Interrelated Investment Restrictions. The CSA has not provided any empirical fact-based evidence of its cost-benefit analysis, but concludes nonetheless that they “do not believe that the proposed Interrelated Investment Restrictions would create substantial costs for non-redeemable investment funds”.

In the absence of grandfathering, this conclusion will not be true for existing NRIFs that do not comply with the proposed Interrelated Investment Restrictions. That NRIFs operate in a manner that is “inconsistent with” mutual funds is the reason they evolved in the first place. This difference is not a negative side-effect of a lack of a regulatory intervention, but instead empirical evidence of the fostering of a fair and efficient capital market. We anticipate that the real cost will be the long-term viability of NRIFs as an asset class as a result of reduced investor choice, product innovation and capital raising.

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Thank you for the opportunity to comment on the Proposed Amendments. We look forward to continued dialogue and consultation with you as these proposals are refined. We would be pleased to meet with the CSA to discuss our suggestions in person to provide additional context and background based on our consultations.

Sincerely,

(Signed) Jeffrey L. Glass
Partner
Blake, Cassels & Graydon LLP

(Signed) Darin R. Renton
Partner
Stikeman Elliott LLP