



**Securities**

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British Columbia Securities Commission  
Alberta Securities Commission  
Financial and Consumer Affairs Authority of Saskatchewan  
Manitoba Securities Commission  
Ontario Securities Commission  
Autorite des marches 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

December 22, 2016

Delivered to:

The Secretary  
Ontario Securities Commission  
20 Queen Street West, 22nd Floor  
Toronto, Ontario M5H 3S8

Via email to: [Comments@osc.gov.on.ca](mailto:Comments@osc.gov.on.ca)

December 22, 2016

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

Dear Sirs/Mesdames:

TD Securities Inc. ("TD Securities") is appreciative for the chance to comment on the Canadian Securities Administrators proposed amendments on the Modernization of Investment Fund Product Regulation – Alternative Funds.

TD Securities is a leading securities dealer in Canada and a top rated Prime Broker. TD Securities has been providing Prime Brokerage Services to alternative investment managers in Canada since 2001.

TD Securities is very supportive of this initiative to make alternative funds available to

Canadian retail investors under National Instrument 81-102 Investment Funds. TD Securities is a leading Canadian Prime Broker and would like to comment on Part 6, Custodianship of Portfolio Assets as we believe that the Proposed Amendments would benefit with some additional modifications. Specifically that qualifying Canadian prime brokers be permitted to act as a custodian of 81-102 regulated alternative funds. We further believe that such modifications are beneficial in order to reflect the operational activities of alternative funds, enhance and modernize the existing regime and ultimately provide Canadian retail investors with more innovative investment products in a way that is both appropriate from a risk perspective as well as being economical and efficient.

Under the Proposed Amendments, alternative funds would be required to retain a custodian for the assets of the fund in a manner similar to that of standard mutual funds. Furthermore, custodians of the assets of alternative funds would be required to follow the same requirements as custodians of conventional mutual funds.

The operational reality for most alternative funds, as a result of the amount of short selling, borrowing and frequency of trading they conduct require them to engage the services of at least one prime broker, but frequently more to custody the majority of their funds' assets. We submit that the proposal to require a separate custodian for the portfolio assets of an alternative fund does not provide any significant additional safeguards for the portfolio assets and would result in increased costs and operational complexities for alternative funds.

Furthermore, prime brokers usually do not act as custodians for conventional mutual funds for several reasons including:

- (i) the qualification requirements under Section 6.2 of NI 81-102;
- (ii) the prohibition on custodians taking security over portfolio assets of investment funds in Section 6.4(3)(a) of NI 81-102;
- (iii) the prohibition on the charging of fees for the transfer of beneficial ownership of portfolio assets in Section 6.4(3)(b) of NI 81-102; and
- (iv) the requirements relating the segregation of assets in Section 6.5 of NI 81-102.

Canadian prime brokers, as members of the Investment Industry Regulatory Organization of Canada ("IIROC") must strictly follow the requirements associated with extending margin and the segregation of assets, as set out by IIROC. Prime brokerage relationships are governed by a prime brokerage agreement which clearly outlines the services and the manner in which they are performed to an alternative fund. We believe that in addition to the operational benefits and cost savings listed above there are sufficient safeguards in place to effectively protect client assets, specifically:

- Cash in a prime brokerage account is not segregated and may be used by the Prime Broker subject to limits set and monitored by IIROC. A prime broker is



liable as a debtor to pay the alternative fund, as creditor, all such amounts.

- A prime broker holds all securities in its accounts for the alternative fund. In a cash account, all securities are fully paid for and are segregated (either in bulk with other client assets or specifically for an alternative fund if a bare trust agreement is entered into).
- In a margin account, alternative funds may borrow against portfolio securities to the extent of their margin value. The securities borrowed against, based on their margin value are not segregated by the prime broker. Short positions in the account that cannot be covered by available cash may also result in securities becoming un-segregated.
- Under IIROC rules, a prime broker may use only un-segregated securities in their business and only to the extent needed to cover a margin loan. For example, if a client has securities worth \$1,000 in its prime brokerage account and owe \$100 on a margin loan, the prime broker would only be able to use securities having a total margin value of \$100. Prime brokers use these securities in the normal course of their business.
- IIROC regulations require firms to review its segregation at the account level each day and to correct any deficiencies (IIROC Rules 2000.4 to 2000.6). A prime broker must take immediate action to correct any segregation deficiency (IIROC Rules 2000.8-9).

TD Securities feels that IIROC registered dealers who meet the criteria to act as a custodian under Section 6.2 of NI 81-102 (specifically, the criteria in Section 6.2(3) (a) and (b), requiring \$10 million of equity and guarantee by the parent bank) should be permitted to act as the custodian or sub-custodian of an alternative fund.

Permitting prime brokers of alternative funds to also act as custodian of the fund would save costs (by eliminating additional counterparties) and would not subject the portfolio assets of the alternative fund to any additional risk as prime brokers qualified to act as custodians will have sufficient capital and must act in accordance with IIROC rules and guidelines when taking and realizing on security or in connection with the segregation of assets.

In addition, 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, the Proposed Amendments will permit an alternative fund to short up to 50% of its NAV, without any change in the custodial provisions set out in Section 6.8.1 which





presents 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 including:

- the time and effort to evaluate and sign multiple prime brokerage/dealer arrangements will be significant and costly for alternative funds.
- Requirement for additional staff to manage daily operational activities such as margin, reconciliations, settlements and tax reporting
- greater costs from the fund administrator due to increased book-keeping and reconciliation requirements.
- smaller accounts would mean less leverage to negotiate favourable pricing and terms of service with prime brokers/dealers.
- the requirement to locate multiple suitable prime brokers may be challenging due to the size of the industry in Canada; and
- other solutions (such as the use of tri-party arrangements) that may allow an alternative fund to comply with the 10% of NAV requirement could be operationally challenging and add additional costs for the alternative fund.

We note that if prime brokers were permitted to act as custodians of alternative funds as we have suggested above, the current language in section 6.8.1 of the Proposed Amendments would not need to be amended.

Thank you for the opportunity to provide you with our comments. Please feel free to contact me should you have any questions or wish to discuss further.

Yours truly,

Steve Banquier  
Managing Director

TD Securities



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