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 Consumer 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

comments@osc.gov.on.ca and consultation-en-cours@lautorite.qc.ca

Re: Canadian Securities Administrators Notice and Request for Comment – Modernization of Investment Fund Product Regulation – Alternative Funds

The Portfolio Management Association of Canada ("**PMAC**"), through its Industry, Regulation & Tax Committee, is pleased to have the opportunity to provide comments on the Canadian Securities Administrators' ("**CSA**") Notice and Request for Comment – Modernization of Investment Fund Product Regulation – Alternative Funds (the "**Proposed Amendments**").

Capitalized terms used in this letter but not defined herein have the same meaning given to them in the Proposed Amendments.

Overview

PMAC represents investment management firms registered to do business in Canada as portfolio managers. PMAC members encompass both large and small firms managing total assets in excess of $1.5 trillion for institutional and private client portfolios[1]. We advocate for the highest standards of unbiased portfolio management in the interest of the investors served by our members.

PMAC is appreciative of the CSA's innovative, thoughtful and ongoing policy work to modernize investment fund product regulation (the "**Modernization Project**") in a way that focuses on

[1] Many of PMAC's members are also registered as investment fund managers that offer a variety of investment products to institutional investors and private clients. For more information about PMAC and our mandate, please visit our website at: www.portfoliomanagement.org.

investor protection while reflecting the significant expansion of investment fund products and strategies available in the market.

We believe that the CSA's approach to the Modernization Project has been constructive and we are appreciative of the proposed new framework that seeks consistency and fairness in the regulatory approach for all investment funds while, at the same time, providing flexibility and investor access to alternative investment strategies that are already available in the exempt market to help individual investors diversify their portfolios and achieve their savings goals.

In a low interest rate environment with unpredictable markets, Canadian investors are seeking to diversify their investments and access higher returns in order to realize their investment objectives. PMAC believes that the enhanced ability to offer diverse funds and strategies that can mitigate risk, take advantage of market inefficiencies or help seek more consistent returns during volatile market conditions can help to maintain investor protection and place Canada more competitively in the rapidly innovating global markets.

PMAC welcomes the comprehensive framework for investment funds set out in the Proposed Amendments. We applaud the CSA's efforts to streamline securities instruments by creating a single, foundational framework applicable to all funds through the repeal of National Instrument 81-104 – *Commodity Pools*, bringing these "alternative funds" under National Instrument 81-102 – *Investment Funds* ("**NI 81-102**"). We believe that this simplification and consolidation of requirements and restrictions is beneficial in terms of consistency, clarity and transparency.

The extent and quality of the debate that PMAC members engaged in on the various consultation topics speaks to the complexity and importance of the alternative funds framework. PMAC members have raised a few matters on which we seek clarification as well as comments for the CSA's consideration on certain aspects of the Proposed Amendments, as further set out below.

Investment Restrictions

Asset Classes

There was a fair amount of debate among members regarding asset classes that are common under typical alternative investment strategies and warrant consideration for inclusion as "alternative funds" under the Proposed Amendments. Certain members, including those with niche expertise and market offerings, will be making their own submissions in support of additional asset classes and strategies used by alternative funds in the exempt market for consideration by the CSA.

Illiquid Assets

As part of the Modernization Project, it may be useful to revisit the definition of "illiquid asset" in NI 81-102. Currently, an illiquid asset is a "portfolio asset that cannot be readily disposed of through market facilities on which public quotations in common use are widely available at an amount that at least approximates the amount at which the portfolio asset is valued in calculating the net asset value per security of the mutual fund". PMAC believes the definition should be updated to reflect that securities that trade in over-the-counter ("**OTC**") markets are not "illiquid assets", provided that they are actively traded on such OTC markets. We believe this would be a welcome clarification and modernization of the definition to reflect current practices.

We believe that the addition of the following underlined wording in the definition of "illiquid asset" would be beneficial:

> "illiquid asset" means:

(a) a portfolio asset that cannot be readily disposed of through market facilities on which public quotations in common use are widely available (which include over-the-counter-markets) at an amount that at least approximates the amount at which the portfolio asset is valued in calculating the net asset value per security of the investment fund or

(b) a restricted security (other than a government or corporate bond) held by an investment fund;

The CSA is soliciting feedback regarding the cap on the amount of illiquid assets held by a fund and with respect to securities being redeemable at net asset value ("**NAV**") once a year.

We note there is a discrepancy between the Proposed Amendments regarding purchases and redemptions for alternative funds and the NAV calculation requirements. While many conventional mutual funds calculate NAV on a daily basis, many hedge funds calculate NAV on a weekly basis – unless they short sell or use specified derivatives in which case the requirement is for a daily NAV calculation (as a result of Section 14.2(3) of National Instrument 81-106 – *Investment Fund Continuous Disclosure*). Under Section 10.3 of NI 81-102, upon redemption, the redemption price of a security must be the next NAV determined after receipt of the redemption order, therefore, if a mutual fund (which under the Proposed Amendments would include an alternative fund) is required to calculate NAV on a daily basis, this could create difficulties for funds redeemable on a weekly or monthly basis.

PMAC notes the carve-out available for alternative funds allowing for the redemption price to be the NAV determined on the first or second business day after the fund receives an order for redemption, but this carve-out does not fully address the logistical challenges that certain alternative funds may face.

NAV calculations associated with purchases will also pose a similar problem for alternative funds under the Proposed Amendments. Pursuant to Section 9.3 of NI 81-102, the issue price of a security of a mutual fund must also be the next NAV determined after the fund has received an order for purchase and there is no similar first or second business day carve-out from this requirement.

While we note that the Proposed Amendments do not prescribe any particular redemption frequency for alternative funds, there are problems with the amendments, as proposed, for alternative funds offering weekly or monthly purchases and redemptions ("**Dealing Days**"). Such funds will need to use multiple issue and redemption prices on any particular single Dealing Day because they will be calculating their NAV on a daily basis and can potentially receive orders every day of the week.

If not corrected, the mismatching of the issue and redemption prices with the NAV on the particular Dealing Day could result in significant operational inefficiency and confusion.

One suggested solution would be to revise Section 10.3(5) of the Proposed Amendments to NI 81-102 in the following way:

> (5) Despite subsection (1) an alternative fund may implement a policy that a person or company making a 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 next redemption date of the alternative fund ~~first or 2nd business day~~ after the date of receipt by the alternative fund of the redemption order.

A corresponding provision should also be added to Section 9.3 of NI 81-102 to address purchases so that the purchase terms for alternative fund securities is consistent with the redemption terms.

PMAC believes that alternative funds should be required to describe their purchase and redemption procedures, including information about purchase and redemption frequency, in their simplified prospectus disclosure.

Borrowing, the Use of Prime Brokers and Short Selling

PMAC supports the flexibility in the Proposed Amendments for alternative funds to borrow up to 50% of their NAV in order to facilitate a wider array of investment strategies than would have otherwise been available, subject to the comments raised below.

A concern raised by members is that the Proposed Amendments restrict funds to borrowing only from entities that qualify as investment fund custodians under Section 6.2 of NI 81-102. As the CSA notes, this restricts borrowing to banks and trust companies in Canada and to a limited subset of their dealer affiliates. The ability to borrow from foreign lenders is, however, important to many alternative funds. For example, certain funds that buy U.S. securities borrow from U.S. Schedule 1 banks to increase efficiency in dealing with the same currency. NI 81-102 has provisions allowing for the recognition of foreign custodians (which include elevated standards) and PMAC believes that a similar framework to allow for foreign lenders would be useful. There is a concern that limiting borrowing only to Canadian financial institutions would reduce competition and potentially also increase borrowing costs since Canadian lenders may charge higher rates for U.S. dollar loans than an American lender. There is also a concern that this approach could increase counterparty risk since all borrowing within the industry would be concentrated. We request that the CSA permit the use of foreign lenders, similar to what is set out in Section 6.2(3) of NI 81-102.

A related concern raised by members is that most hedge funds open margin accounts to borrow cash and/or securities with prime brokers (who are typically registered dealers) that may not meet the custodian requirements of Section 6.2 of NI 81-102. We encourage the CSA to engage in further analysis of whether the alternative fund rules can be broadened in this respect to allow for the use of prime brokers by alternative funds.

Prime brokers offer a customized bundle of services to funds, as well as a centralized master account, in addition to lending cash and securities to the funds. The agreements between funds and prime brokers grant the prime broker a security interest over the assets held in such accounts and permit the prime broker to use those assets in the ordinary course of their business. PMAC believes that the borrowing rules should be amended to permit the participation of prime brokers and that they should be expanded to include non-Canadian banks and their affiliated dealers (subject to meeting certain appropriate criteria set by the CSA) in order to allow alternative funds to continue to make use of prime brokers – both Canadian and non-Canadian - and non-Canadian banks and dealers in furtherance of their current strategies.

Currently, many private pooled funds hold their portfolio assets through prime brokers. Subject to appropriate safeguards implemented by the CSA, permitting the use of prime brokers in the alternative fund space may be beneficial in order to allow funds to continue to use their prime brokers for their custody arrangements and for borrowing purposes.

The CSA may also wish to further examine whether to exempt alternative funds from the 10% specified derivatives limit on assets held as collateral in a prime broker account and, in lieu of that limit, for larger funds with a certain amount of assets under management, require the participation of at least two prime brokers. Including prime brokers in the custodial requirements in NI 81-102 for alternative funds could be an effective way of promoting the use of hedge funds. Requiring two prime brokers for these larger funds could assist in limiting counterparty risk. It is often impractical and inefficient for funds to be required to maintain a custodial account alongside a number of

lending relationships and a number of derivatives counterparties. Since the financial crisis, most funds have engaged multiple prime brokers to mitigate counterparty risk and it may be preferable to require funds to have two (or more) prime broker accounts and to focus on the quality and capitalization of the prime brokers as a more effective way to mitigate risk than to impose a counterparty limit on assets held as collateral.

Members also raised concerns with the 50% limit on borrowing, as they believe that restricting borrowing in this way may push funds towards the use of derivatives that may introduce more risk in order to achieve the fund's strategies.

There was also debate among members about the merits of capping the ability of alternative funds to short sell at 50%, with some members taking the view that the 50% cap is appropriate for investor protection and others raising concerns that capping the ability to short sell could - similar to the concerns on the cap on borrowing - push alternative funds to use derivatives to achieve their strategies which may serve to heighten risk. PMAC suggests further consultation may be required on the impact of the 50% limit on short selling.

Members further commented that government bonds should be exempt from the 10% issuer concentration limit on the short selling restrictions. The short sale of government securities is used primarily as an interest rate hedge as they can be more efficient, cost effective and carry a lower risk than hedging the interest rate risk with derivatives. We believe that Section 2.6.1 of the Proposed Amendments should exclude government securities from the short sale single issuer concentration limit. We believe this would be consistent with the exemption of government securities from the long issuer concentration limit in Section 2.1(2)(a) of the Proposed Amendments.

PMAC further suggests that the calculation of borrowed amounts be net of cash and cash equivalents held in the same account. This situation may arise where an alternative fund invests in securities denominated in a foreign currency and the fund's mandate requires the fund to hedge any foreign currency risk.

Certain members have noted it is common for alternative funds and non-redeemable funds to provide a security interest over their portfolio assets in order to secure loans. To that end, these members have suggested that Section 2.6(2)(c) of the Proposed Amendments be modified in order to allow a security interest to be granted over such funds' portfolio assets, provided that it is done in accordance with normal industry practices and on standard commercial terms for the type of transaction.

Total Leverage Limit

There was extensive discussion around the CSA's inquiry regarding which types of strategies currently employed by commodity pools and closed-end funds will be impacted by the proposed 3 times leverage limit. The complexity and divergence of opinions PMAC heard around the advisable quantum of the leverage limit for certain types of funds and strategies suggests that this is an area that warrants further exploration and consultation by the CSA.

Generally, members noted that the "notional amount" used to calculate total leverage does not have a defined meaning beyond "generally recognized standards" to determine such amount – as specifically set out in Section 3.6.3 of NI 81-102. PMAC welcomes further clarification from the CSA as to their expectation regarding the "notional amount", including examples of generally recognized standards in the Companion Policy to NI 81-102 – perhaps including the use of margin to equity - to resolve some ambiguity around this concept.

PMAC also believes that managers ought to be permitted to classify certain derivatives (such as foreign exchange forwards, interest rate swaps and government bond futures) and certain short sales (such as government bonds) used for hedging purposes as excluded from the total leverage

calculation. This is because these types of derivatives and short sales are designed to reduce risk and to limit a fund's ability to use them may encourage funds to turn to riskier derivatives. Short sales that are classified as hedges should also be excluded from the 50% limit on short selling for the same reason.

The CSA has indicated that it is soliciting feedback on alternative leverage measurement methods that may better reflect the amount of, and potential risk to a fund from, leverage than the currently proposed method.

Members presented various alternative methods of calculating leverage for consideration by the CSA. Though no one methodology was endorsed by all members, and, while certain members are supportive of the methodology set out in the Proposed Amendments, the debate demonstrated that the industry supports the adoption of a straight-forward method of leverage calculation - and perhaps leveraging the work already done in Europe on this point - that accurately reflects a fund's exposure as well as the need for further consultation on the appropriate methodology. Members will be making individual submissions on suggested alternative leverage calculation methodologies reflecting their international experience and fund-specific concerns.

Disclosure

PMAC is supportive of the public disclosure requirements in the Proposed Amendments as the requirement to have a receipted prospectus, publish Fund Facts and make available financial statements with position level transparency provides investors with a more consistent disclosure regime than the offering memoranda through which alternative funds are currently offered to investors. Disclosure will be an important way for the mechanics of these alternative funds to be explained to retail investors.

We also urge the CSA to undertake, in conjunction with the industry, a public education campaign about the features, risks and benefits of investing in these new products as a way to bolster investor protection, literacy and the growth of these important asset classes and strategies for the benefit of Canadians. The oversight of these funds by the CSA through the prospectus filing process should serve as an additional investor protection mechanism.

Similar to what was done upon the introduction of Fund Facts and the recent ETF Facts – and which industry found to be very helpful – we ask the CSA to publish a sample of the new form of required disclosure.

Proficiency

PMAC looks forward to reviewing the specific proficiency requirements for the sale of alternative funds. We believe that these proficiency standards should be designed with investor protection in mind as well as to ensure that a sufficient number of qualified individuals will be available to sell these funds so that they are widely available to retail investors.

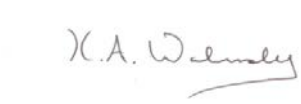
Concluding Comments

The ability for retail investors to have access to alternative asset classes and strategies which are currently only available to high net worth and institutional investors in the exempt market marks a major, but positive, shift for Canadian retail investors. We thank the CSA for the dedication they have demonstrated through the various phases of the Modernization Project. We believe that everyday Canadian investors and our economy can benefit from modern, innovative investment opportunities offered through a well-regulated legal framework. We also appreciate the considerable efforts taken by the CSA to extensively consult with stakeholders, to evaluate the various alternatives that the Modernization Project could have taken and to balance the need for retail investor participation in the alternative fund space with the need for investor protection.

We would be pleased to speak with you further about the remarks in our letter.

Sincerely,

PORTFOLIO MANAGEMENT ASSOCIATION OF CANADA



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