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To: The Secretary
Ontario Securities Commissions
Email: comments@osc.gov.on.ca

London, 06 January 2017

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

Dear Sir or Madam,

The Hedge Fund Standards Board (HFSB) welcomes the Canadian Securities Administrators' (CSA) efforts to develop a more comprehensive framework for publicly offered alternative funds. The HFSB regularly provides input on various international regulatory consultations to develop and modernise regulatory frameworks for alternative investments, bringing our unique combination of manager and investor perspectives to the table.

One area of particular interest is the CSA's approach to leverage in investment funds. We note that the CSA proposes a single gross leverage limit of 3 times the fund's NAV.[1] We note that the topic of leverage has been widely consulted on in a number of regulatory consultations in recent years, including the EU Alternative Investment Fund Manager Directive (AIFMD)[2], the Financial Stability Board (FSB) consultations on Proposed Policy Recommendations to Address Structural Vulnerabilities from Asset Management Activities (2016), Oversight of NBNI G-SIFIS (2014)[3] and Strengthening Oversight on Shadow Banking (2012)[4].[5] We have participated in each of these consultations.

In its recent response to the FSB consultation on vulnerabilities in asset management, the HFSB included an analysis of different leverage measures; this highlights some of the shortcomings of gross leverage as a measure or risk. Specifically, we would like to draw the CSA's attention to section

[1] CSA consultation paper: https://www.lautorite.qc.ca/files/pdf/reglementation/valeurs-mobilieres/81-102/2016-09-22/81-102-avis-ACVM-en.pdf p.9
[2] Links to the AIFMD and the HFSB consultation responses to the various AIFMD consultations are available here: http://www.hfsb.org/regulatory-engagement/aifmd/
[3] NBNI G-SIFIS: Non-bank non-insurer Globally Systemic Financial Institutions. Particular focus on gross notional exposure (GNE) to identify NBNI G-SIFIS; the HFSB response highlighted the limitations of GNE
[4] The consultation paper explores "leverage limits" (Question 4); the HFSB consultation response addresses this on page 13 (http://www.hfsb.org/wp-content/uploads/2016/04/hfsb_response_to_fsb_consultation_14_01_2013final.pdf)
[5] Links to all FSB consultations and HFSB responses are available here: http://www.hfsb.org/regulatory-engagement/financial-stability/

3 (p.10ff) of the HFSB consultation response (overview of characteristics of different leverage measures). Some of the key observations in relation to the gross method are set out below:

- The gross method does not account for hedges *(i.e., a hedging transaction (reducing portfolio risk) can increase gross leverage but reduces overall risk)*
- It does not account for the riskiness of the underlying assets *(a low risk portfolio consisting of government bonds with high leverage might still be less risky than an emerging markets equities portfolio with low leverage; notional amounts do not reflect the maturity/underlying of derivative contracts)*
- Gross leverage is not suitable for (risk) comparison purposes between different investment strategies *(many investors employ different approaches to calculate leverage for different investment strategies (Equities, Fixed Income, Currencies, Convertible Bonds…) to obtain a more accurate perspective on risk (usually in combination with other risk measures))*
- The AIFMD does not set out an absolute leverage limit, and the AIFMD commitment method seeks to address a number of the short-comings of gross leverage measures, e.g. by accounting for netting of certain exposures (see p.12ff in the HFSB consultation response for a more detailed analysis of different methodologies)
- The UK FCA highlighted in its 2015 hedge fund survey[6] (which focusses on identifying systemic risk) that gross notional exposure (GNE) (which is used to calculate gross leverage) "does not directly represent an amount of money (or value) that is at risk of being lost" but, instead, represents the gross size of positions taken in the market. The Survey also acknowledged "that hedge funds use risk management techniques to net out directional exposures". Therefore, the UK FCA also refers to the "market footprint" in the context of GNE.
- It also is worth noting that a "hard-wired" leverage limit in certain scenarios can increase distress: in situations where market prices fall, a regulatory leverage limit can exacerbate market price movements, by forcing investors to sell/unwind positions (in order not to exceed the regulatory leverage limit), when in fact the investor might be prepared to hold on to the asset. A leverage limit can also restrict a manager's ability to manage risk in such situations (through hedging etc.).

We hope that this summary assessment is helpful to enhance the understanding of leverage, highlight some of the limitations of gross leverage measures, and further the CSA's efforts to developing a meaningful framework for alternative investments in Canada.

Sincerely,

Thomas Deinet

Executive Director

[6] FCA Hedge Fund Survey, 2015, p. 19: Definition of gross notional exposure and gross leverage https://www.fca.org.uk/publication/data/hedge-fund-survey.pdf