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Financial and Consumer Affairs Authority of Saskatchewan
The Manitoba Securities Commission
Ontario Securities Commission
Autorité des marchés financiers
Financial and Consumer Services Commission of New Brunswick
Registrar of Securities, Prince Edward Island
Nova Scotia Securities Commission
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RE: Canadian Securities Administrators ("CSA") Notice and Request for Comment Modernization of Investment Fund Product Regulation – Alternative Funds (the "Proposed Amendments")

Arrow Capital Management Inc. ("Arrow") supports the CSA's objective to move most of the regulatory framework currently applicable to commodity pools under NI 81-104 into NI 81-102 and rename these funds as "alternative funds". Arrow feels particularly supportive of the AIMA Canada's comments on the Proposed Amendments listed below, and in some cases have added further relevant commentary.

1. General Comments

AIMA Canada strongly supports the initiative to make alternative funds available to retail investors in Canada under National Instrument 81-102 Investment Funds ("NI 81-102" or the "Instrument") and we feel that, overall, the CSA have made a highly commendable effort in striking the appropriate balance amongst the investment restrictions, disclosure requirements and proposed distribution channels for alternative funds. However, we believe that there are several modifications to the Proposed Amendments and some additional amendments which, if adopted, will assist in fully realizing the goal of modernizing the existing commodity pool regime and providing Canadian retail investors with access to more innovative investment strategies in a manner which is efficient as well as appropriate from a risk perspective.

In considering comments received and potential changes to the Proposed Amendments, we urge the CSA to keep in mind the impact of any new requirements or regulations on the structuring and operating costs of smaller investment managers who may wish to offer investment products under NI 81-102. If the bar to entry is set too high, it would be prohibitive for the majority of the smaller investment managers to contemplate providing alternative funds to retail investors in Canada and only the largest institutions, such as Canadian banks and large mutual fund companies that have the resources and existing distribution networks would end up benefiting from the Proposed Amendments.

2. CSA Questions

Definition of "Alternative Fund"

1) Under the Proposed Amendments, we are seeking to replace the term "commodity pool" with "alternative fund" in NI 81-102. We seek feedback on whether the term "alternative fund" best reflects the funds that are to be subject to the Proposed Amendments. If not, please propose other terms that may better reflect these types of funds. For example, would the term "nonconventional mutual fund" better reflect these types of funds?

Response:

AIMA Canada agrees with the replacement of the term "commodity pool" with "alternative fund" and with the use of the term "alternative fund" in NI 81-102. The term "alternative fund" and the associated definition of this term in the Proposed Amendments is more representative of the various types of investment strategies that can be implemented in this category of investment funds.

Under the Proposed Amendments the CSA has proposed to adopt a similar approach to the definition of "alternative fund" in NI 81-102 as is currently used to define a "commodity pool" in NI 81-104. We would recommend that the definition of "alternative fund" be slightly modified

as follows to more closely parallel the stated approach of the Proposed Amendments and account for the operational distinctions between alternative funds and conventional mutual funds:

> "alternative fund means a mutual fund**, other than a precious metals fund,** that has adopted fundamental investment objectives that permit it to invest in asset classes**,** ~~or adopt~~ **use** investment strategies **or implement operational features that are not permitted by this Instrument** ~~that are otherwise prohibited~~ but for **certain** prescribed exemptions ~~from Part 2 of~~ **contained in** this Instrument;"

We would also like to bring the CSA's attention the fact that there are a number of conventional mutual funds that are currently offered that incorporate the terms "Alternative" or "Liquid Alternative" in the name of the fund. As part of the Proposed Amendments, we would expect that guidance on this point would be included in the Companion Policy to NI 81-102 that these funds would either have to convert to an alternative fund or be required to change their fund names to remove these references in order to avoid potential confusion with new alternative funds among investors. Similarly, new investment funds offered under NI 81-102 should not be permitted to use the word "alternative" in their fund name in a manner that suggests that they are an alternative fund in order to prevent confusion in the market.

Investment Restrictions

Asset Classes

2) We are seeking feedback on whether there are particular asset classes common under typical "alternative" investment strategies, but have not been contemplated for alternative funds under the Proposed Amendments, that we should be considering, and why.

Response:

Generally speaking, we believe that most traditional alternative investment strategies currently offered on a private placement basis to high net worth investors would be permitted (in some cases with minor modifications) under the definition of "alternative fund" and the investment restrictions contained in the Proposed Amendments. However, we note that the leverage limits on alternative funds in section 2.9.1 of the Proposed Amendments will negatively impact the ability of managed futures, relative value and global macro strategies to operate efficiently. In addition, as discussed in more detail below, the ability to offer market neutral strategies would be severely impacted and the single issuer shorting restrictions will significantly hamper alternative strategies that hedge risk through the use of instruments such as government securities and index participation units.

(a) Market Neutral Strategies Should be Eligible to be Offered as Alternative Funds

While not a separate asset class, market neutral is a common investment strategy that will be

particularly affected for alternative funds under the Proposed Amendments.

The investment objective of a market neutral strategy is to remove market risk (i.e. the risks of significant swings in the market) by balancing long and short positions in an effort to provide returns in all market conditions. A market neutral strategy can provide true diversification in an investment portfolio as it is intended to be uncorrelated to the market. However, in order to employ a true market neutral strategy, a fund must be permitted have short and long positions of up to 100% of net asset value ("NAV"). Given the maximum short position limit of 50% of NAV for alternative funds in Section 2.6.1(c)(v) of NI 81-102, it would be practically impossible for a true market neutral investment strategy to be offered as an alternative fund.

Although it may be technically possible for an alternative fund to replicate a market neutral strategy under the Proposed Amendments through a combination of short-selling and specified derivatives, such an approach would be inefficient and more costly to implement than a "pure" market neutral strategy.

We submit that market neutral strategies can play an important role in removing market risk in an investor's portfolio and should be eligible to be offered as an alternative fund under the Proposed Amendments. This could be accomplished by including a definition of "market neutral fund" in the Proposed Amendments as follows:

> "market neutral fund" means an alternative fund that has adopted a fundamental investment objective of maintaining a neutral exposure to a broad group of securities identified by sector, industry, market capitalization or geographic region through the use of long positions and short positions

A corresponding exception to the 50% of NAV short sale limit could then be included for market neutral funds which would permit such funds to have short positions up to 100% of NAV.

(b) Government Securities and IPUs Should be Exempt from Single Issuer Short Sale Limit

At present, there are exemptions from the concentration restriction in section 2.1 of NI 81-102 for government securities, index participation units ("IPUs") issued by investment funds as well as investment funds purchased in accordance with the requirements of section 2.5 of NI 81-102 (which would include exchange traded funds that do not qualify as IPUs). There are similar exemptions from the control restriction in section 2.2 of NI 81-102.

We submit that, as is the case for long positions, government securities, IPUs and securities of other exchange traded funds should correspondingly be exempt from the single issuer concentration limit of 10% of NAV of the fund contained in subsection 2.6.1(iv) of NI 81-102. Such a change would permit a greater variety of risk-reducing hedging strategies to be offered to retail investors in alternative funds.

Concentration

3) We are proposing to raise the concentration limit for alternative funds to 20% of NAV at the time of purchase, meaning the limit must be observed only at the time of purchasing additional securities of an issuer. Should we also consider introducing an absolute upper limit or "hard cap" on concentration, which would require a fund to begin divesting its holdings of an issuer if the hard cap is breached, even passively, which is similar to the approach taken with illiquid assets under NI 81-102? Please explain why or why not.

Response:

AIMA Canada supports the concentration limit of 20% of NAV for alternative funds measured as at the time of purchase. However, we do not support the introduction of an upper limit or hard cap on concentration. The imposition of a hard cap concentration limit could result in forced sales of assets with higher transactional costs at distressed prices which would not be in the interests of investors. We submit that not having a hard cap allows alternative funds to better manage an orderly unwind of positions in excess of the 20% concentration limit thereby maximizing disposition proceeds and contributing to a lower level of market volatility.

Illiquid Assets

4) We are not proposing to raise the illiquid asset limits for alternative funds under the Proposed Amendments. Are there strategies commonly used by alternative funds for which a higher illiquid asset investment threshold would be appropriate? Please be specific.

Response:

AIMA Canada submits that the illiquid asset limit for alternative funds be raised to 15% of NAV (with a hard cap of 20% of NAV). We believe that these increased limits would permit much more flexibility for alternative investment strategies and allow for exposure for retail investors to additional alternative asset classes under NI 81-102.

In connection with the Proposed Amendments, we would strongly encourage the CSA to use this opportunity to clarify the definition of "illiquid asset" in NI 81-102. The definition currently includes such terms as "readily disposed of", "market facilities", "public quotations" and "restricted securities" that are not defined and in respect of which there is no broad consensus within the industry. As such, the term continues to be difficult to interpret and apply in practice, particularly in respect of significant asset classes including syndicated loans, high yield debt, corporate bonds and emerging-market sovereign and quasi-sovereign bonds that trade primarily in the over-the-counter markets ("OTC").

We submit that the CSA should amend the definition of "illiquid asset" to expressly include OTC pricing that is determined on an arm's length basis and remove references to market

facilities and public quotations to better reflect industry practices with respect to these types of securities. In the alternative, we submit that the CSA should adopt the approach taken by the United States Securities and Exchange Commission ("SEC") for open-ended funds under Rule 22e-4 adopted by the SEC in an October 13, 2016 release ("Release") [available at: https://www.sec.gov/rules/final/2016/33-10233.pdf]. 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. This definition replaces longstanding SEC guidance that a fund asset should be considered illiquid if it cannot be sold or disposed of in the ordinary course of business within seven (7) days at approximately the value ascribed to it by the fund. The two components of the SEC liquidity test: (a) the number of days required to achieve liquidity and (b) a sale price that is not significantly different from the market value of the investment, we submit, are more relevant than nature of the market or quotations associated with such liquidity.

5) Should we consider how frequently an alternative fund accepts redemptions in considering an appropriate illiquid asset limit? If so, please be specific. We also seek feedback regarding whether any specific measures to mitigate the liquidity risk should be considered in those cases.

Response:

Generally speaking, we submit that liquidity is of little relevance or concern where an alternative fund or a non-redeemable investment fund have limited redemptions and of no relevance or concern where such a fund is not redeemable. Our view is consistent with the International Organization of Securities Commissions ("IOSCO") principles on liquidity. The alignment of liquidity with the redemption obligations and other liabilities of open-ended funds is a principle recommended in IOSCO's "Principles on Suspensions of Redemptions in Collective Investment Schemes" [available at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD367.pdf] and reiterated in a report published in March 2013 entitled "Principles of Liquidity Risk Management for Collective Investment Schemes" in which they recommended fifteen principles [available at http:// www.iosco.org/library/pubdocs/pdf/IOSCOPD405.pdf.]

Redemptions and NAV Calculation

We would like to bring the CSA's attention the discrepancy between the regime for purchases and redemptions of alternative funds under the Proposed Amendments and the requirements to calculate NAV. Under the current regime in Section 14.2(3) of National Instrument 81-106 Investment Fund Continuous Disclosure ("NI 81-106"), investment funds are required to calculate NAV weekly, unless they use specified derivatives or short sales, in which case they are required to calculate NAV daily. Pursuant to 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. If a mutual fund is required to calculate NAV daily (as would be the case for many alternative funds), this would create a real difficulty for funds redeemable on a weekly or

monthly basis.

The Proposed Amendments (in section 10.3) adopt the carve-out for alternative funds currently available to commodity pools, which allows the redemption price of a security to be the NAV determined on the first or second business day after receipt of the redemption order. However, while this may slightly lessen the problem for weekly alternative funds, it by no means solves it.

A similar disconnect will exist for purchases of securities of an alternative fund 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 receiving the purchase order. In this case however, the carve out for the first or second business day provided for redemptions described above does not exist.

While we acknowledge that the Proposed Amendments do not prescribe any particular redemption frequency for alternative funds, the obvious problem for alternative funds offering weekly or even monthly purchases and redemptions as of a specific day ("Dealing Days") is that they will have multiple issue and redemption prices on any particular single Dealing Day as they will be required to calculate NAV on a daily basis and could potentially receive (purchase and/or redemption) orders each day of the week. Taken to its extreme, an alternative fund with a monthly Dealing Day may be required to issue securities at up to 30 different NAVs on the same Dealing Day.

If this issue is not addressed, the mismatching of the issue and redemption prices with the NAV on the particular Dealing Day will result in significant operational inefficiencies and confusion. Accordingly, we strongly encourage the CSA to correct this inconsistency. One possible solution would be to revise Section 10.3(5) of the Proposed Amendments to NI 81-102 as follows:

> "(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 be added to Section 9.3 of NI 81-102 to address purchases. The purchase terms for securities of alternative funds should be consistent with the redemption terms for such funds.

We would encourage the CSA to adopt a consistent approach for the purchase and redemption of securities of alternative funds similar to the approach to the payment of incentive fees in the Proposed Amendments (Section 7.1(2)). Specifically, an alternative fund should be required to

describe its purchase and redemption procedure in its simplified prospectus (including details relating to the frequency of purchases and redemptions).

Another example of the problem would be for alternative funds that adopt a "fund of funds" investment strategy as permitted under NI 81-102 and allocate all or a significant portion of the fund's investment portfolio to non-redeemable investment funds. It would be nearly impossible for such a fund to comply with the next NAV redemption requirements that would be applicable to alternative funds under the Proposed Amendments because of the infrequent redemption schedule of non-redeemable investment funds and the trading price (usually at a discount to NAV) being the only source of liquidity. Alternative funds would be better able to manage their redemption schedule if the redemption price payable is permitted to be based on the NAV at the regularly predetermined Dealing Day.

Borrowing

8) Should alternative funds and non-redeemable investment funds be permitted to borrow from entities other than those that meet the definition of a custodian for investment fund assets in Canada? Will this requirement unduly limit the access to borrowing for investment funds? If so, please explain why.

Response:

Under the Proposed Amendments alternative funds would only be permitted to borrow cash from entities that qualify as investment fund custodians under Section 6.2 of NI 81-102 which would restrict borrowing from Canadian banks and trust companies and their dealer affiliates.

(a) *Prime Brokers*

We acknowledge that the Proposed Amendments are intended to permit alternative funds to borrow from dealers that act as prime brokers in Canada. However, it is important to note that while the equity of most bank affiliated dealers exceeds $10,000,000, they do not prepare separate financial statements that are "made public" as contemplated by Section 6.2(3)(a) of NI 81-102. This was acknowledged as part of the definition of "Canadian custodian" in the recent proposed amendments to National Instrument 31-103 Registration Requirements, Exemptions and Ongoing Registrant Obligations ("NI 31-103"), which adopted the definition from Section 6.2 of NI 81-102 but removed the language "that have been made public".

To give effect to the stated intention of permitting alternative funds to borrow from dealers that act as prime brokers in Canada we recommend that, for the purposes of borrowing the requirement under Section 6.2(3)(a) of NI 81-102 that the dealers' financial statements have been made public should be removed, which would be consistent with the proposed changes NI 31-103.

We further submit that the alternative qualification requirement in Section 6.2(3)(b) of NI 81-102 that the bank has assumed responsibility for all of the custodial obligations of the dealer should remain unchanged.

In addition, the Proposed Amendments would prohibit alternative funds from borrowing from investment dealers that are not affiliated with a bank. While most dealers that act as prime brokers in Canada are affiliated with banks, the Proposed Amendments would necessarily exclude independent investment dealers from this market. In this regard, we refer to the proposed amendments to NI 31-103 discussed above and the inclusion of an investment dealer that is a member of the Investment Industry Regulatory Organization of Canada ("IIROC") in the definition of "Canadian custodian". We submit that, for the purposes of borrowing, consideration should be given to permitting alternative funds to borrow from an investment dealer that is a member of IIROC, consistent with the definition of "Canadian custodian" in the proposed amendments to NI 31-103.

(b) *Foreign Lenders*

The ability to borrow from foreign lenders is important to many alternative funds. Alternative funds should be permitted to borrow from foreign financial institutions as this will increase available sources of funding (especially for alternative funds trading in U.S. dollars) and may result in better terms of borrowing for alternative funds. Many alternative funds that trade U.S. securities borrow from U.S. banks and dealers to increase efficiency. We submit that that the borrowing requirements should be expanded to include non-Canadian banks and dealers in order to allow alternative funds to make use of both Canadian and non-Canadian lenders in furtherance of their investment strategies, subject to such entities meeting applicable qualification criteria for foreign investment fund sub-custodians under NI 81-102.

We recommend that Section 2.6(2)(a) of the Proposed Amendments to NI 81-102 be slightly modified as follows:

> "(a) the alternative fund or non-redeemable investment fund may only borrow from an entity described in section 6.2 **or 6.3**;"

(c) *Netting of Cash and Cash Equivalents*

We recommend that the proposed cash borrowing limit of 50% of NAV under the Proposed Amendments should be calculated net of any cash and cash equivalents held in the same account.

Total Leverage Limit

9) Are there specific types of funds, or strategies currently employed by commodity pools or non-redeemable investment funds that will be particularly impacted by the proposed 3 times leverage limit? Please be specific.

Response:

There are no limitations on the aggregate notional exposure under specified derivative transactions under the current regime applicable to commodity pools. We understand that many existing commodity pools may not be able to comply with the 300% leverage limit on the notional value of derivatives used by the pool. As the investment strategies of these existing funds were established to comply with the current regime, we recommend that these commodity pools be grandfathered in and permitted to continue to operate under an exemption from the 300% leverage limit in the Proposed Amendments subject to complying with the other requirements applicable to alternative funds under NI 81-102. We submit that, in many cases, to require existing commodity pools to reduce the level of leverage used through specified derivatives will result in the investment strategy used by the pool becoming wholly ineffective and requiring such commodity pools to cease operations.

10) The method for calculating total leverage proposed under the Proposed Amendments contemplates measuring the aggregate notional amount under a fund's use of specified derivatives. Should we consider allowing a fund to include offsetting or hedging transactions to reduce its calculated leveraged exposure? Should we exclude certain types of specified derivatives that generally are not expected to help create leverage? If so, does the current definition of "hedging" adequately describe the types of transactions that can reasonably be seen as reducing a fund's net exposure to leverage?

Response:

AIMA Canada has significant concerns at a global level regarding the proposal to restrict total exposure for alternative funds through borrowing, short selling or the use of specified derivatives to the proposed limit of 300% of the fund's NAV in section 2.9.1 of NI 81-102. As currently proposed to be calculated and coupled with a ceiling of 300% of NAV, the leverage limit not only would have a disastrous impact on some existing commodity pools, it would also have a significant negative impact on the ability to offer effective managed futures, relative value market neutral and global macro alternative investment strategies.

We would encourage the CSA to consider removing the hard leverage limit of 300% of NAV from section 2.9.1 and to instead require disclosure of the maximum amount of leverage the alternative fund may use and the method for calculating leverage by the alternative fund. Removal of the 300% leverage limit would permit existing commodity pools to continue to operate and would broaden the types of alternative strategies that could be made available to retail investors under NI 81-102.

There are generally recognized industry standards in Canada, the U.S. and other jurisdictions to determine the notional amount of exposure under a specified derivative that are used by investment fund managers for risk management, reporting and other purposes. We believe that

the approach adopted under the Proposed Amendments would allow alternative funds to use these industry standard calculation methods for the purposes of calculating the fund's exposure under the Proposed Amendments. As set out in the companion policy to NI 81-102 under the Proposed Amendments, this preferred approach will permit alternative funds to apply the same methodology consistently when calculating their aggregate gross exposure as well as calculating their NAV.

For the information of the CSA, we attach as Appendix "A" to this Comment Letter an AIMA White Paper comparing leverage measures in for investment funds between the United States and the United Kingdom.

Notwithstanding the above, if the CSA decide to retain the 300% of NAV total leverage limit in the Proposed Amendments we submit that alternative funds should be able to subtract or disregard certain offsetting transactions and positions in specified derivatives that do not create leverage to reduce their calculated leveraged exposure.

We acknowledge the CSA position that hedging transactions do not necessarily fully offset the risk of any particular position and disregarding the notional value of all hedging transactions from the calculation of aggregate gross exposure may misstate a fund's true leverage position. At this time, we would not propose a change to the definition of "hedging" under NI 81-102 or to exclude all hedging transactions from the calculation of total leverage. Although, certain offsetting transactions described below should be specifically excluded

We recommend that immediate offsetting transactions in fungible securities that do not create any additional leverage or exposure and should be disregarded for the purposes of the calculation. By way of example, we note that IIROC Rule 100.4 addresses a variety of offsetting positions which are generally not included in the calculating leverage. The essential features of these transactions is that the long position is fungible into the short position and is convertible (however, any costs of converting the offsetting position would be included in the leverage calculation).

We also recommend that alternative funds, in determining the aggregate gross exposure, 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. This carve-out would apply to specified derivatives transactions for which an alternative fund would use an offsetting transaction to effectively settle all or a portion of the transaction prior to expiration or maturity, such as certain futures and forward transactions. It would also apply to situations in which a fund seeks to reduce or eliminate its economic exposure under a specified derivatives transaction without terminating the transaction.

In addition, we recommend that the Proposed Amendments include a carve-out provision that would permit an alternative fund, in determining aggregate gross exposure, to disregard any

specified derivatives entered into for the purpose of specifically offsetting: (i) foreign currency exposure; (ii) interest rate exposure; and (iii) single-name credit exposure, as these transactions are entered into to eliminate economic exposure in whole or in part. The carve-out provision would permit an alternative fund to exclude from its aggregate gross exposure the notional amounts associated with specified derivative transactions that are entered into by the alternative fund to specifically offset foreign currency exposure or interest rate risk of the fund's portfolio assets, as well as single-name credit default swaps to offset the credit risk of fixed income securities issued by a single debt issuer.

A fund that wants to fully or partially neutralize the foreign currency, interest rate or credit exposure of specific investments by entering into a specified derivative should be able to disregard the notional amount of the offsetting transaction for the purposes of the fund's overall leverage limit.

Our proposed carve-out for these offsetting transactions is not designed to enable a fund to generally disregard the notional amount of specified derivative transactions involving foreign currency, interest rates or credit exposure. Rather, the provision would only apply to specified derivative transactions that directly offset or reduce risks associated with all or a portion of an existing investment or position of the alternative fund. These types of transactions do not create leverage or increase a fund's net exposure to leverage and are some of the most common specified derivative transactions entered into for the purposes of managing risk.

11) We note that the proposed leverage calculation method has its limits and its applicability through different type of derivatives transactions may vary. We also acknowledge that the notional amount doesn't necessarily act as a measure of the potential risk exposure (e.g. interest rate swaps, credit default swaps) or is not a representative metric of the potential losses (e.g. short position on a futures), from leverage transactions. Are there leverage measurement methods that we should consider, that may better reflect the amount of and potential risk to a fund from leverage? If so, please explain and please consider how such methods would provide investors with a better understanding of the amount of leverage used.

Response:

Generally speaking we agree that the notional amount of a specified derivative does not always reflect the way in which the fund uses the derivative and that it is not a direct measure of risk. The obvious example being that two different specified derivatives having the same notional amount but different underlying reference assets may expose a fund to very different investment risks. AIMA's position is that there should be multiple (rather than a single) measures of leverage used in order to address the variability of strategies in the alternative investment universe, and that clear, plain and true disclosure be used to outline how leverage is being used to either enhance returns, or in many cases, to combine related securities in an effort to reduce the capital at risk in the portfolio.

<u>Disclosure</u>

Fund Facts Disclosure

13) Are there any other changes to the form requirements for Fund Facts, in addition to or instead of those proposed under the Proposed Amendments that should be incorporated for alternative funds in order to more clearly distinguish them from conventional mutual funds? We encourage commenters to consider this question in conjunction with proposals to mandate a summary disclosure document for exchange-traded mutual funds outlined in the CSA Notice and Request for Comment published on June 18, 2015.

Response:

We submit that it may be difficult to include all of the information contemplated by the CSA for an alternative fund in the text box disclosure of the fund facts document and to still stay within the space constraints of the document. We suggest that it would make more sense to include a description of the asset classes and/or investment strategies used by the alternative fund that cause it to fall under the definition of "alternative fund" in NI 81-102 under the description of what the fund invests in the fund facts document and to use the text box disclosure to highlight any differences in the redemption terms for an alternative fund compared to a conventional mutual fund as well as the sources and uses of leverage, any specific risk factors that an investor should consider as a result of the asset classes invested in, or investment strategies utilized by the alternative fund to either enhance return or reduce specific risks in the portfolio. We submit that these changes would make the fund facts document significantly more meaningful to retail investors.

AIMA Canada strongly objects to any suggestion that alternative strategies may "affect investor's chance of losing money on their investment in the alternative fund" as was commonly the case for warnings included in the prospectus of commodity pools. Each alternative fund should be evaluated on the basis of the particular investment strategies and asset classes in which it invests and clear disclosure of any risks that should be considered in conjunction with such strategies or asset class should be made in the fund's disclosure documents. We note that to require any disclosure for alternative funds but not for non-redeemable investment funds or conventional mutual funds implies that alternative funds are riskier and more likely to lose money when this is not the case. We do not consider such a distinction to be warranted or appropriate.

AIMA Canada believes that investors should be provided with all meaningful information which should be considered prior to making an investment decision. Specifically, if the changes to the Proposed Amendments suggested in this comment letter are alternative funds may have different timing for purchases, redemptions and risk methodologies which should be highlighted for investors. We suggest that it would be extremely helpful to industry participants if the CSA

were to provide a pro forma alternative fund facts document for further consultation and comment prior to the final amendments coming into force.

14) It is expected that the Fund Facts, and eventually the ETF Facts, will require the risk level of the mutual fund described in that document to be disclosed in accordance with the CSA Risk Classification Methodology (the Methodology) once it comes into effect. In the course of our consultations related to the Methodology, we have indicated our view that standard deviation can be applied to a broad range of fund types (asset class exposures, fund structures, manager strategies, etc.). However, in light of the proposed changes to the investment restrictions that are being contemplated, we seek feedback on the impact the Proposed Amendments would have on the applicability of the Methodology to alternative funds. In particular, given that alternative funds will have broadened access to certain asset classes and investment strategies, we seek feedback on what modifications might need to be made to the Methodology. For example, would the ability of alternative funds to engage in strategies involving leverage require additional factors beyond standard deviation to be taken into account?

Response:

AIMA Canada believes that the Methodology should be consistent between conventional mutual funds and alternative funds. We also believe that fund managers should have the ability to consider risk measures other than standard deviation as long as this is disclosed to the investor. We would recommend that the Methodology be revisited and adjusted in conjunction with the finalization of the Proposed Amendments as several elements of the Proposed Amendments will impact the overall risk profile of the fund.

There will likely be challenges for some alternative fund managers in complying with the new risk classification rules published in final form on December 8, 2016 and we recommend that some further consideration be given to how risk classifications will apply to alternative funds prior to the publication of the final amendments to NI 81-102 in order to ensure that alternative funds will be able to properly calculate and disclose risk to investors.

<u>Point of Sale</u>

15) We seek feedback from fund managers regarding any specific or unique challenges or expenses that may arise with implementing point of sale disclosure for non-exchange traded alternative funds compared to other mutual funds that have already implemented a point of sale disclosure regime.

Response:

Although smaller investment managers may initially face challenges and increased expenses (compared to existing mutual fund managers) in meeting the requirements, AIMA Canada

believes that the three month transition period set out in the Proposed Amendments should generally provide an adequate amount of time to implement a point of sale disclosure regime.

4. Transition

16) We are seeking feedback on the proposed transition periods under the Proposed Amendments and whether they are sufficient to allow existing funds to transition to the updated regulatory regime? Please be specific.

Response:

AIMA Canada supports the proposed transition period of three months from the final publication date for alternative funds. However, we note that some existing closed end funds and commodity pools that are adversely impacted by the changes to the investment restrictions in the Proposed Amendments may require more time to bring themselves into compliance with the restrictions (assuming that they are not grandfathered).

5. Other Comments on the Proposed Amendments

In addition to our Responses to the specific questions posed by the CSA, AIMA Canada has the following comments on other aspects of the Proposed Amendments.

Counterparty Exposure Limits (Section 2.7(4))

We do not agree with the elimination of the counterparty exposure exemption for alternative funds and non-redeemable investment funds. It is not clear that there is any risk from exposure to a single counterparty that needs to be mitigated.

The following comment has been made by others previously, including ISDA in their comment letter dated October 17, 2002 on proposed amendments to National Instrument 81-102 Mutual Funds and, in particular, on those aspects of NI 81-102 relating to swaps [available at: http://www.isda.org/speeches/pdf/osc-com-letter101702.pdf].

We submit that, under Section 2.7(4) of NI 81-102, the calculation of the mark-to-market value of the exposure of an investment fund to a counterparty should be net of credit support provided by the counterparty. This is because the provision of credit support eliminates the credit risk of the counterparty. We note that such credit support was provided by counterparties to non-redeemable investment funds that entered into pre-paid forward purchase and sale transactions with such counterparties.

Custodians of Alternative Funds (Part 6 of NI 81-102)

Under the Proposed Amendments, alternative funds would be required to appoint a custodian for the assets of the fund in the same manner as conventional mutual funds and custodians/sub-

custodians of the assets of alternative funds would be required to adhere to the same requirements as custodians/sub-custodians of conventional mutual funds.

The operational reality for most alternative funds (arising from the frequency of trading, the amount of short selling conducted and the amount of borrowing and derivatives utilized by the fund) require the alternative fund to lodge the majority of its assets with one or more prime brokers. 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.

Prime brokers do not typically 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.

In addition, although not a requirement, prime brokers can offer their clients the most efficient and cost-effective services if they are able to rehypothecate the non-segregated assets held in their client accounts. This has not generally been an issue for conventional mutual funds due to restrictions on leverage in NI 81-102, but for alternative funds that will be able to borrow and short sell up to 50% of NAV, permitting rehypothecation of collateral would significantly reduce transaction costs. This may also even the playing field somewhat between alternative fund managers and larger mutual fund companies who may be able to garner preferential terms from prime brokers if rehypothecation were not permitted.

In this regard, we submit that the portfolio assets of alternative funds will not be subject to any greater level of risk of loss. Prime brokers must adhere to the requirements of IIROC relating to the taking of security (margin) and the segregation of assets and the prime brokerage relationship is governed by the terms of the prime brokerage agreement. 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).

We note that, as part of amendments proposed for NI 31-103 in July of this year, the CSA contemplated that registered investment dealers who are members of IIROC would be permitted to act as custodians in Canada for the assets of privately offered investment funds.

AIMA Canada respectfully submits that registered dealers who are members of IIROC and who otherwise meet the qualification 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 or guarantee by the parent bank) should be permitted to act as the custodian or sub-custodian of an alternative fund. We also reiterate our comment relating to borrowing above that the requirement in Section 6.2(3)(a) of NI 81-102 that dealers' financial statements "have been made public" should be removed.

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.

Custodial Provisions relating to Short Sales (Section 6.8.1)

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 would function much more effectively. Notwithstanding this fact, we would submit that a 20% of NAV deposit limit with borrowing agents (other than the fund's custodian or sub-custodian) as security for short sales by alternative funds would provide alternative funds with the flexibility to engage the services of two or more prime brokers (other than their custodian or sub-custodian) in an effort to execute their investment strategies in a more efficient manner and to help alleviate potential counterparty risk.

Historical Performance Record (Part 15 of NI 81-102)

A number of AIMA members have indicated that the investment strategies utilized by their

existing privately offered pooled funds could fit within the investment restrictions for alternative funds under the Proposed Amendments. In these circumstances, it may be desirable for these funds to become alternative funds under the Proposed Amendments by filing a simplified prospectus. Although, Section 15.6(1)(a) of NI 81-102 contains a prohibition against the inclusion of performance data in sales communication for a mutual fund that has been distributing securities under a prospectus for less than 12 consecutive months.

Accordingly, an investment fund manager of an existing pooled fund with a suitable strategy that wanted to convert the existing pooled fund into an alternative fund by filing a simplified prospectus would not be able to include the historical track record of the pooled fund in the sales communications pertaining to the alternative fund.

The Proposed Amendments represent one of most significant developments in the Canadian investment industry in some time and given the unique nature of these changes we recommend that the CSA provide a limited exemption from the prohibition contained in Section 15.6(1)(a) of NI 81-102 to permit alternative funds that convert from a pooled fund to include their historical performance data in their sales communication with the appropriate qualifications. Without this information, investors will not be able to obtain a complete picture of the skill of the alternative fund manager and the behaviour of the alternative strategies employed by the fund. AIMA Canada considers this information (with the relevant caveats) to be vital for investors who will not be familiar with this space.

Presentation of Financial Highlights in NI 81-106

We have the following specific comments relating to the presentation of financial highlights by mutual funds under NI 81-106.

Calculation of Management Expense Ratio and Trading Expense Ratios

We submit that due to the use of short selling and/or borrowing by alternative funds, the costs associated with such alternative investment strategies will significantly impact an alternative fund's expense ratio. As there is limited guidance on the inclusion of these expenses in either Management Expense Ratio ("MER") or Trading Expense Ratio ("TER"), we are concerned that there will be inconsistent treatment resulting in less comparability across different funds. Since these expenses, including dividend and interest expense on short sales and related short sale borrowing fees, as well as borrowing interest expense costs, are incurred in the course of execution of the alternative strategy, we recommend that the CSA provide guidance that confirms these expenses should be included as part of TER. Such treatment would be in line with other transaction costs which are currently included in TER, however it would treat interest expense on borrowing as TER rather than the current practice of including this expense as part of the MER. We submit that our recommended treatment of these expenses for alternative funds

would better align costs with the execution of the strategy (i.e. transactional in nature) rather than as an operating expense of the alternative fund.

Total return and total annual compound return calculations

NI 81-106 currently requires returns to be bifurcated and presented separately for long and short investments during the relevant period. We submit that the requirement to bifurcate long and short returns for alternative funds be removed as the current disclosure requirement would result in misleading information for investors both as it relates to fund performance as well as providing a complete understanding of the strategy and risk of the alternative fund. For example, various alternative strategies involve the execution of long-short "paired" trades or the use of short sales to hedge an element of market or interest rate risk such that the position is only relevant when one considers the combined long and short components. One must also take into account that specified derivatives are used by some alternative investment strategies instead of short sales to achieve a similar result. Thus, presentation of performance bifurcated between long and short positions will not allow an investor to understand the performance of the fund and will only promote misunderstanding and confusion.

Proficiency

We note that the CSA intends to engage with the Mutual Fund Dealers Association ("MFDA") in order to determine the appropriate proficiency requirements for dealing representatives of mutual fund dealers to distribute securities of alternative funds. AIMA Canada has a vast array of educational and other resources available relating to alternative investment strategies and we would be very pleased to offer our assistance to the CSA and MFDA in this regard.

We appreciate the opportunity to provide the CSA with our views on the Proposed Amendments. Please do not hesitate to contact us with any comments or questions that you might have.

Sincerely,

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