BLACKROCK®

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Submitted via electronic filing: comments@osc.gov.on.ca; consultation-en-cours@lautorite.qc.ca

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

Attention:
Josée Turcotte
Ontario Securities Commission
20 Queen Street West
22nd Floor
Toronto, ON 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, QC H4Z 1G3

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

Dear Sirs/Mesdames:

A. About BlackRock

BlackRock Asset Management Canada Limited ("**BlackRock Canada**" or "**we**") is an indirect, wholly-owned subsidiary of BlackRock, Inc. ("**BlackRock**") and is registered as a portfolio manager, investment fund manager and exempt market dealer in all the jurisdictions of Canada and as a commodity trading manager in Ontario.

BlackRock is one of the world's leading asset management firms. We manage assets on behalf of institutional and individual clients worldwide, across equity, fixed income, liquidity, real estate, alternatives, and multi-asset strategies. Our client base includes pension plans, endowments, foundations, charities, official institutions, insurers, and other financial institutions, as well as individuals around the world.

B. General Observations

BlackRock commends the Canadian Securities Administrators ("**CSA**") on its ongoing work to modernize investment fund product regulation and to help facilitate more alternative and innovative strategies for retail investors. As a general principle, we support initiatives that encourage long-term savings by broadening the choice of investments offered to investors. Providing market participants with the enhanced ability to offer retail investors diverse investment strategies that seek to mitigate risk, capitalize on market inefficiencies or deliver more consistent returns in volatile markets can further the CSA's goal of investor protection while enhancing Canada's competitiveness in rapidly innovating global markets.

The Proposed Amendments mark a major shift in the Canadian market, and as such, we encourage the CSA to take a holistic, outcome-driven approach to implementing any regulation, while emphasizing its underlying policy goals. In particular, we recommend that the CSA be thoughtful and deliberate in its approach in distinguishing between "alternative" and "conventional" funds, with a particular focus on investment strategies that relate to leverage, liquidity and overall portfolio volatility. Regulations which introduce ambiguity surrounding which investment strategies are permitted to be used by conventional funds, and which are reserved solely for alternative funds could be exploited by some industry participants, ultimately misleading investors. Clear and specific guidance surrounding allowable and prohibited investment strategies that emphasizes substance over form and with an explicit relationship to policy objectives would benefit industry participants and investors alike.

Beyond this general caution, we have questions and concerns regarding certain of the Proposed Amendments as they relate to alternative funds, which are set out in greater detail below. For ease of reference, we have included the full text of each consultation question to which our comments correspond.

We are also supportive of the Proposed Amendments that would modernize and provide increased flexibility to conventional mutual fund strategies. To that end, we have taken this opportunity to identify certain other areas of National Instrument 81-102 – *Investment Funds* ("**NI 81-102**") which we believe also merit further consideration for modernization.

C. BlackRock's Responses

1. Proposed Amendments Relating to Alternative Funds

A. 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?

BlackRock supports the replacement of the term "commodity pool" with "alternative fund" and believes it is reflective of the funds that would be subject to the Proposed Amendments.

B. 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.

BlackRock supports the CSA's proposals to provide alternative funds with increased flexibility to use long/short strategies. We note, however, that setting the proposed limit on the aggregate market value of all securities that may be sold short by an alternative fund at 50% of net asset value ("**NAV**") could preclude certain common alternative strategies from being offered under the proposed framework, including market neutral strategies.

Market neutral strategies generally seek to generate returns based on perceived pricing asymmetry while limiting general market exposure, often by taking long positions in securities considered undervalued, while taking short positions in securities considered overvalued. As market neutral funds tend to employ long/short positions in up to 100% of a portfolio's NAV, the current framework, as proposed, may serve to either prohibit these strategies from being offered or inadvertently increase the risk by disallowing shorting beyond the 50% limit. Market neutral strategies aim to provide returns that are unrelated to those of the overall stock market, and can offer investors significant diversification potential. In addition, since market neutral strategies are designed to mitigate risk, a fully long-short market neutral portfolio could have significantly less risk than a portfolio with 50% of NAV in short positions. In this respect, we recommend that the CSA revisit the Proposed Amendments as they relate to such strategies, with an emphasis on risk mitigation rather than prescriptive limitations. In addition, we suggest that the 50% limitation on shorting apply on a net rather than gross basis.

A. 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.

BlackRock supports the proposed increase of the concentration limit for alternative funds to 20% of NAV at the time of purchase and suggests extending this same flexibility to conventional mutual funds. We note that NI 81-102 already contains an exemption from the 10% concentration limit for an index participation unit that is a security of a mutual fund[1], and recommend that this exemption be extended to non-index products as well, subject to enhanced disclosure regarding increased concentration risk (similar to what is currently required for index mutual funds). We believe this increased limitation will still provide the potential for meaningful diversification while allowing greater flexibility in investment strategies and increased options for investors.

B. Illiquid Assets

[1] Section 2.1(2)(d) of NI 81-102

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.

We agree with the underlying principle that a limitation on the amount of illiquid assets that can be held by a mutual fund is appropriate, and that setting reasonable controls on and monitoring the use of illiquid assets can reduce the risk to end investors. We believe, however, that the current definition of "illiquid assets" in NI 81-102 is unclear, and does not adequately further these principles.

Currently, "illiquid assets" are defined as "*portfolio assets that cannot be readily disposed of <u>through market facilities on which public quotations in common use are widely available</u> at an amount that at least approximates the amount at which the portfolio asset is value in calculating the net asset value per security of the mutual fund*". The underlined phrase is difficult to interpret when dealing with securities that commonly trade in over-the-counter ("**OTC**") markets such as fixed income securities, and creates ambiguity surrounding the liquidity of these securities for regulatory purposes, even when they are actively traded. Refining this definition to more appropriately capture OTC traded securities would be a welcome clarification in order to reflect current market practices and align with the CSA's policy goals.

C. <u>Borrowing</u>

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.

BlackRock 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. We are concerned, however, 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 their dealer affiliates. We note that many products currently offered in the alternative space utilize prime brokers to provide customized bundles of services, including execution, custody, lending and margin financing. While the CSA mentions in the summary of comments to the Proposed Amendments that dealers that act as prime brokers in Canada would qualify as eligible custodians under s. 6.2 of NI 81-102[2], we recommend that the CSA revise the borrowing rules to clearly permit the use of prime broker entities, including non-Canadian banks and their affiliated dealers in order to allow alternative funds to continue to make use of prime brokers. In order to mitigate potential counterparty risk, the CSA could consider requiring alternative funds to utilize a minimum of two prime brokers.

More generally, the ability to borrow from foreign lenders is important for many funds, as it has the potential to increase efficiency and reduce costs. As the current proposals would concentrate borrowing to a small number of Canadian entities, widening the ambit of potential lenders could also serve to limit counterparty risk. To address these concerns, we encourage the CSA to introduce provisions allowing for the recognition of foreign lenders, similar to the framework currently in existence for foreign custodians.

[2] Proposed Amendments, Page 8070.

D. Leverage

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.

It is important to note that leverage within portfolios can be used for many reasons, aside from strictly speculation. These uses include hedging (mitigating) risks to which the portfolio is subject, replicating the characteristics of physical securities, managing volatility, enabling better liquidity, and generating portfolio exposures to implement an investment view. While it is true that many derivatives may introduce notional leverage into a portfolio, the economic exposure and overall risk of the portfolio will vary depending on both the intended use of the derivative and the instrument utilized.

In this regard, while we are supportive of the CSA defining a comprehensive measure of leverage, we believe that any leverage limit imposed should incorporate a measure of economic exposure obtained through the use of leverage (and accounting for the fact that derivatives used for hedging do not create leverage). Notional exposure, while helpful for providing a base level indication of the overall use of derivatives by a fund, is not appropriate for use as a leverage limit. When used in isolation and without consistent adjustment for risk, notional exposure does not provide a meaningful indication of the risk associated with the use of leverage for the vast majority of portfolios, and could result in misleading conclusions made by investors about the risk exposure of a fund. A comprehensive measure of economic exposure obtained from the use of leverage ("economic leverage") that incorporates borrowings and derivatives and is consistent with global standards is the best approach to introducing a leverage limit in NI 81-102.

Rather than implementing a new standard, we encourage the CSA to instead consider the existing methods of calculating risk used in Europe under the Undertakings For the Collective Investment in Transferable Securities ("**UCITS**") and the European Alternative Investment Fund Managers Directive ("**AIFMD**") frameworks. While imperfect, we believe these are well established means of limiting or measuring leverage in funds. The AIFMD method includes both a calculation of gross notional exposure, as well as a measure of economic leverage that captures borrowings and structural leverage stemming from derivatives positions with exclusions for offsetting and hedge positions (the "**Commitment Approach**"). The UCITS framework permits fund managers to calculate risk exposure based on either an approach similar to the Commitment Approach, or Value at Risk ("**VaR**"), a commonly used measure of risk that estimates how much a set of investments might lose, given normal market conditions, in a set time period. Harmonizing the CSA's approach with global standards would lead to both international consistency and ease of use and implementation for Canadian market participants.

2. Other Suggested Amendments

We strongly support the Proposed Amendments to NI 81-102 that would provide additional flexibility for conventional mutual funds, namely expanding the scope of permitted investment in physical commodities and reducing the limitations on fund of fund structures. While these Proposed Amendments are welcome and useful, there are certain other areas of NI 81-102 we believe also merit further attention in order to better achieve the CSA's goal of modernizing investment fund product regulation in Canada.

A. Specified Derivatives

As we understand it, the policy objectives underpinning the rules relating to the use of specified derivatives by conventional mutual funds in ss. 2.7, 2.8 and 2.9 of NI 81-102 are twofold: 1) limiting of the use of leverage; and 2) managing counterparty risk. As discussed above, we acknowledge that the use of derivatives can present risk, and agree with the implementation of reasonable limits on derivatives exposure within conventional mutual fund portfolios. In our view, however, streamlining and simplifying these rules could better achieve the CSA's intended outcomes.

Specifically, the current rules with respect to leverage and cash cover are overly complex in that they require fund managers to classify derivative instruments based on defined categories. This is an increasingly difficult exercise given the growth and evolution of derivatives. Derivatives, by their very nature, are a fluid and evolving category, and regulation should recognize this. Structuring rules around rigid categorizations or even colloquial names can also be ineffective, as it is possible to produce the same economic exposure using a variety of different instruments or combinations of instruments. Further complicating the analysis is the requirement to distinguish between "long" and "short" positions in certain assets. This distinction is not always straightforward, as many derivatives include elements of both long and short economic exposure. The application of the cash cover requirements and related definitions is also not entirely clear. Namely, the concept of "underlying market exposure" is difficult to interpret when dealing with contracts with a theoretical notional amount; e.g., interest rate futures.

Rather than focusing on specific labels and categorizations, we would encourage the CSA to instead clarify and reconsider these rules with a view to taking a more principles based approach to the regulation of derivatives use by investment funds. We suggest that the rules focus on the nature of the instrument used, and the overall economic exposure and risk of a portfolio. Taking such an approach will better align with the CSA's overall policy goals, and will provide greater consistency and simplicity for investors and industry participants alike.

With respect to counterparty risk, we would encourage the CSA to revisit the definitions of "designated rating" and "equivalent debt" in NI 81-102. In our view, the definition of designated rating is unduly restrictive in that it requires industry participants to monitor the ratings provided by all four named designated rating agencies on a continuous basis. The CSA itself notes that fewer firms have been able to attain a designated rating since the financial crisis, and has proposed relief from this requirement for alternative funds to provide them with access to a greater number of counterparties[3]. We believe that access to a larger variety of counterparties would also benefit conventional mutual funds in terms of pricing, managing counterparty risk through diversification and product choice, ultimately benefitting end investors.

We suggest that the CSA consider the recent Dodd-Frank reforms implemented in the United States[4], which require the replacement of mandatory credit-ratings in securities legislation with

[3] Proposed Amendments, page 8056

[4] Dodd-Frank Wall Street Reform And Consumer Protection Act of 2010, s. 939A

other more appropriate standards. As an example, the Securities and Exchange Commission recently removed the credit rating requirements in money market fund legislation, instead limiting money market funds to investing in a security only if the fund determines that the security presents minimal credit risks after analyzing certain prescribed factors[5].

Similarly, we feel that the definition of "equivalent debt" is rife for reform. Matching the term of an evidence of indebtedness to the term of a derivative instrument is often a difficult exercise, and is not an accurate determination of the length of the obligation. We suggest that this definition instead simply refer to credit rating of the counterparty or guarantor, as applicable.

Finally, we welcome further guidance surrounding the interpretation of the 10% counterparty exposure limitation in s. 2.7(3) of NI 81-102 and encourage the CSA to consider how, if at all, this exposure could be mitigated through collateralization rather than rigid limitations.

B. Securities Lending

As another modernization initiative, we suggest that the CSA revisit the rules relating to permitted collateral in securities lending transactions.[6] Amending the collateral schedule to allow for the delivery of equities would put NI 81-102 funds on par with other global products who accept equities as collateral, including UCITS funds in Europe, and would increase the competitiveness of Canadian funds in the global securities lending market. As a risk mitigation mechanism, agent lenders and fund managers would determine the appropriate level of collateralization for these securities, at all times meeting the 102% market value minimum threshold in NI 81-102.[7]

D. Conclusion

BlackRock appreciates the opportunity to provide input on this important regulatory initiative and would be pleased to make appropriate representatives available to discuss any of these comments with you. We would also be happy to participate in any roundtable discussions.

Sincerely,

"Margaret Gunawan"

Margaret Gunawan
Chief Compliance Officer and Secretary, BlackRock Asset Management Canada Limited

[5] Securities and Exchange Commission, 17 CFR Parts 270 and 274. https://www.sec.gov/rules/final/2015/ic-31828.pdf

[6] NI 81-102, s. 2.12(6)

[7] NI 81-102, s. 2.12(5)(b)