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Nova Scotia Securities Commission
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Registrar of Securities, Yukon Territory
Superintendent of Securities, Nunavut

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Dear Sirs/Mesdames:

Re: CSA Notice and Request for Comment

Modernization of Investment Fund Product Regulation – Alternative Funds published for comment September 22, 2016

We are lawyers in the Investment Management practice group of Borden Ladner Gervais LLP and we work with many fund managers and their investment funds (mutual funds, closed-end funds and ETFs) that are regulated by National Instrument 81-102 *Investment Funds* (NI 81-102), as well as with fund managers and their commodity pools that are now regulated by NI 81-102 and National Instrument 81-104 *Commodity Pools* (NI 81-104). We also act for many fund managers and their investment funds that today are not regulated by NI 81-102, because those fund managers have chosen not to qualify their securities for sale to the public, given the restrictions that would apply to them under NI 81-102 if they chose to do so. Many of those fund managers did not wish to take advantage of NI 81-104 for various reasons, including the fact that there are significant distribution challenges and rather onerous consequences of being considered a "commodity pool" under that instrument.

We have closely followed and commented on the numerous changes to NI 81-102 that have been proposed and implemented in the past number of years, and have strongly supported the CSA in its efforts to develop an alternative funds regime.

We note that our lawyers participated in various working groups of industry associations to assist them in developing their comment letters. Michael Burns is the Chair of the Alternative Investment Management Association (AIMA) and provided input into our letter, as well as into the AIMA letter. We also participated in the working groups and reviewed the comment letters of The Investment Funds Institute of Canada and the Portfolio Management Association of Canada while finalizing our letter.

We are pleased to provide our views on the most recent proposals for amendments to NI 81-102 and the related instruments, and support the concepts behind the proposed alternative funds regime. Our comments highlight some amendments that we consider should be made for clarity and/or to allow for practical adoption and implementation of the regime by industry participants, so as to achieve the objectives of the CSA, which we understand to be enhancing investment opportunities for investors by allowing for access to liquid alternative investment asset classes and strategies. In our view, the proposed alternative funds regime will provide Canadian retail investors with access to more innovative investment strategies, which are still appropriate from a risk perspective, while also providing them with useful disclosure that is suited to the specific type of investment vehicle.

We greatly appreciate the practice of the CSA over the past few years to publish blacklined copies of the instruments being amended. This significantly enhances our ability to grasp the significance of what is being proposed and allows us to more easily provide comments to the CSA.

Our comments should not be taken as the views of BLG, other lawyers at BLG or our clients.

We provide our comments in the order of the various instruments, and their provisions, that were published for comments. We have chosen to answer certain of the CSA's questions where we feel we have particular expertise and experience.

Comments on NI 81-102 Amendments

1. Commentary on division of NI 81-102 into rules relating to "alternative funds", mutual funds and non-redeemable investment funds

Overall we agree with the proposals of the CSA to divide the world of publicly offered investment funds into these broad categories, although we note that there are a number of different sub-sets of these categories, each with slightly different requirements and some of which are overlapping. We recommend that the CSA consider a discussion in the Companion Policy about these categories and the implications of being one or the other. Please see also our comments below on the definition of "non-redeemable investment fund".

We prepared for our clients a table indicating the various requirements that will apply to each type of investment fund, if the amendments are adopted, which may serve as a useful format for the Companion Policy. Our Investment Management Bulletin accompanies this letter.

2. Part 1 – section 1.1 - Definition of "alternative fund"

In answer to the CSA's first question about replacing the term "commodity pool", with "alternative fund", we strongly agree that the term "commodity pool" is a misnomer and is not readily understandable by investors, whereas "alternative fund" is more comprehensible and plainly stated.

As currently drafted in the proposed amendments to NI 81-102, it is the fundamental investment objective of the mutual fund that determines whether a mutual fund is an alternative fund, by either allowing for investment in asset classes or by the adoption of investment strategies that would not otherwise be permissible. However, in many cases, it is the investment *strategies* of a fund, and not the investment objective, per se, that makes a mutual fund an alternative fund. Accordingly, the definition of "alternative fund" should be revised to make it clear that an alternative fund is a mutual fund that has adopted either fundamental investment objectives or investment strategies that permit it to invest in asset classes or financial instruments in a manner that is otherwise prohibited by Part 2 of NI 81-102, but for prescribed exemptions. If the CSA consider that the

definition works as drafted, then we recommend that further discussion of this point be included in the Companion Policy to NI 81-102 so as to alleviate any confusion.

We also note from the CSA's commentary in the response to comments and generally in the CSA notice that there is no intention (at present) for the CSA to implement required naming conventions for alternative funds; for example, by requiring the fund names to highlight that the funds are "alternative funds". We agree with this approach. However, we strongly recommend that the CSA commentary in the response to comments be included in section 2.01 of the Companion Policy of NI 81-102 for future clarity and on-going understanding, given that CSA statements in Notices become increasingly difficult to find in years following a rule's adoption.

We point out that the CSA may wish to discourage future conventional mutual funds from using the word "alternative" in their names and in the description of their investment strategies. We are not aware that this practice is wide-spread, but we consider that this is a point that the CSA may wish to make in the Companion Policy, so as to avoid any uncertainty in the minds of investors (and their advisors) as to the status of the particular fund. Any conventional mutual fund that currently has the word "alternative" in its name may wish to consider changing or supplementing its name to ensure clarity. This name change should not require a securityholder vote and should not be considered to be a material change; we recommend that the CSA emphasize this point.

We also recommend that the CSA add a brief paragraph to section 2.01 of the Companion Policy clarifying that it is not intended that all "precious metals funds" are alternative funds; that is, simply because precious metals funds invest in one or more precious metals does not mean that they fall within the definition of alternative fund. There has to be more to the fund than simply investing in precious metals. It would be helpful to clarify that an alternative fund *could* include a fund that invests in precious metals provided there are other investment objectives and/or strategies followed by that fund that brought it within the alternative fund world.

Related to our comments on the "alternative funds" definition, we have considered the CSA's second question – namely whether there are particular asset classes common under typical alternative investment strategies, but have not been contemplated for alternative funds under the amendments.

We understand that many in the industry would like the CSA to move towards a better recognition of the place that "market neutral" strategies have in an investing strategy for investors.

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 market neutral strategy, a fund must be permitted to have short and long positions of up to 100% of net asset value (NAV). Given the maximum short position limit of 50% of NAV suggested for alternative funds in section

2.6.1(c)(v) of NI 81-102, it will be difficult for a pure market neutral investment strategy to be offered as an alternative fund under this instrument.

Although it may be technically possible for an alternative fund to replicate a market neutral strategy under the proposed amendments through the use of short-selling and specified derivatives, such an approach would be inefficient and more costly to implement.

We submit that market neutral strategies can play an important role in removing market risk in an investor's portfolio and should be permissible as an alternative fund under NI 81-102. An exemption could be made to the proposed 50% of NAV short sale limit for funds that hold themselves out as market neutral. This would permit such a fund to have short positions up to 100% of NAV.

3. Part 1 – section 1.1 - Definition of "cleared specified derivative"

The definition of "cleared specified derivative" does not distinguish between two of the principal participants in the derivatives industry: the futures commission merchants that execute and clear exchange-traded derivatives and the clearing corporations that clear over-the-counter derivative transactions. While the blurring of these distinct functions may currently work as drafted, we submit that as new derivative rules continue to be refined and to come into effect in Canada, it will be necessary to distinguish between exchange-traded derivatives and cleared derivatives under NI 81-102. We suggest that the definition of cleared specified derivative be split into two definitions, as follows:

(a) "cleared specified derivative" means a specified derivative that is cleared through a regulated clearing agency

(b) "exchange-traded specified derivative" means a specified derivative that trades on a futures exchange or an options exchange and that is executed and cleared through a dealer that is registered or exempt from registration under the laws of the jurisdiction of the mutual fund.

4. Definition of "non-redeemable investment fund"

We strongly recommend that the CSA take the discussion about what is (and is not) a non-redeemable investment fund that is presently found in NI 81-106 and its Companion Policy and include it in NI 81-102 and its Companion Policy, so that this instrument can be an all-encompassing instrument and a "one-stop" shop for understanding the CSA's division of the public fund universe. Some participants do not think to look to the Companion Policy of NI 81-106, and we feel that the industry and their advisers, alike, will benefit from this amendment. We recognize that NI 81-106 also needs to have this discussion, given that it applies to public and private issuers and the latter issuers need to understand if they are "investment funds" or not.

We also recommend that the CSA consider updating the NI 81-106 Companion Policy discussion, particularly as it relates to clarifying the recent thinking about what investment vehicles the CSA considers NOT to be an investment fund, which has been

subject of some consternation within the industry and the legal community, and, in our view, deserves public consultation. Some of the discussion that is in section 1.3 of the Companion Policy to NI 31-103 and CSA Staff Notice 81-722, for instance, as it relates to private equity and venture funds, as well as mortgage investment entities, could be usefully incorporated into the Companion Policy to NI 81-102 (and NI 81-106, if the discussion is duplicated), to clarify that these funds (if publicly offered) are not considered to be investment funds and are not subject to the rules of NI 81-102. This area (that is, what is and what is not an investment fund) is generally poorly understood; we would be very pleased to discuss this issue further with CSA staff.

5. Section 2.3

In our view, subsection (4) does not work as the CSA appear to intend or if it does, it's a somewhat meaningless exclusion in our view. We understand the "look through" test in subsection (3), but we believe that a top fund should be able to exclude an investment by ANY investment fund (not just an IPU or a stock or bond index) that the top fund invests in, if that investment represents less than 10 percent of the NAV of that underlying fund. In our view, it does not make sense to restrict subsection (4) to underlying IPU investments or stock or bond indices.

6. Section 2.4

We note the CSA's intention to consider further rules, including risk management techniques relating to liquidity risk management for investment funds, which is mentioned in the CSA Notice and Request for Comment and would welcome the opportunity to provide input into this discussion at an appropriate time. We consider that there is a real need for further clarity and thought on this issue. In our view, this topic and the scope of the definition of illiquid assets deserves further commentary and consultation not necessarily tied to the alternative funds proposals.

7. Section 2.6

As a drafting matter, subsection (1) should be made subject to subsection (2) for alternative funds and non-redeemable investment funds. In addition, subsection (2) should clarify that an alternative fund and a non-redeemable investment fund may grant security interests over any of their portfolio assets in connection with borrowings that are permitted under this subsection. This is specifically permitted under subsection (1), but not subsection (2), which it should be.

More substantively, we consider that borrowing from a related party is not such an insurmountable conflict of interest – it is certainly not otherwise prohibited - that this practice deserves IRC "approval", as opposed to a positive recommendation. We note that many in the fund industry enter into related party agreements, such as portfolio management or other services provision, where IRC "approvals" are not contemplated. We do not view a borrowing arrangement to be materially different from these other related party services agreements.

In our view, subparagraphs (a) and (b) of subsection (2) should be drafted with the following changes for clarity and consistency:

(a) The alternative fund or non-redeemable investment fund ~~may only~~ borrows from an entity described in section 6.2 and section 6.3 [see further below]

(b) If the lender is an affiliate [or associate? – *see further page 8174 of the OSC Bulletin edition of the CSA Notice – Section 6 of the amendments to NI 81-101 refers to "associates"*] of the investment fund manager of the alternative fund or non-redeemable investment fund, the independent review committee of the alternative fund or non-redeemable investment fund must provide a positive recommendation to proceed with ~~has approved must approve~~ the applicable borrowing agreement after such proposed lending arrangement has been referred to the IRC under subsection 5.1 of NI 81-107.

We also urge the CSA to permit alternative funds to borrow from non-Canadian lenders, which we understand is a common practice for alternative funds so as to allow for more efficiencies relating to loans in foreign currencies to allow for transactions in those foreign currencies.

8. Section 2.6.1

Please see our references to market neutral funds in connection with our comments on the definition of "alternative funds" in comment 2 above. This section should be modified to permit these strategies.

We also consider that there is a need to exclude government securities and IPUs from the single issuer "short selling" limits provided for in paragraph 2.6.1 (1)(c)(ii) and (iv). This exclusion is just as relevant for short selling as it is for long positions and should apply to all types of investment funds in this context, as it does for long positions.

9. Section 2.6.2

Please see our references to market neutral funds in connection with our comments on the definition of "alternative funds" in comment 2 above. This section should be modified to permit these strategies.

10. Section 2.7(4) (5)

We consider that alternative funds and non-redeemable investment funds should be exempt from these provisions (counterparty exposure).

It is not clear to us that there is any risk from exposure to a single counterparty that needs to be mitigated. 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 is commonly required under most derivative transactions and rules are currently being drafted and implemented that will make the posting of collateral mandatory under most over-the-counter derivative transactions.

11. Section 2.9.1

We agree that it is important for an investor to understand the amount of leverage in the portfolio of an alternative fund or a non-redeemable investment fund. For this reason, the leverage calculation should be as simple as possible. While a leverage calculation based on the aggregate notional amount of an investment fund's specified derivatives position may be simple to understand, we submit that this calculation results in a distorted view of the fund's actual exposure under its derivatives positions. In most cases, a fund's liability under its derivatives positions is significantly less than the notional amount of those derivatives. In addition, if a leverage limit is imposed on these investment funds to mitigate risk, then specified derivatives that are entered into for offsetting hedging purposes in order to reduce a risk in the portfolio should not be included in the leverage calculation. In order to not unduly restrict the investment strategies of these funds, we submit that it would be more appropriate to only require disclosure of the leverage ratio of the funds, and not to impose a limit on the amount of permitted leverage. As you know this is the manner in which leverage is presently dealt with under NI 81-104.

As we note above, there are no limitations on the aggregate notional exposure under specified derivative transactions under the current regime applicable to commodity pools. Similarly, there are existing closed-end funds that have strategies that do not comply with the proposed 50% combined borrowing and short sale restrictions. As the investment objectives and strategies of any existing funds were established to comply with the current regime, we recommend that existing commodity pools and closed-end funds be grandfathered in and permitted to continue to operate under an exemption from any leverage limits (if any are adopted) subject to complying with the other requirements applicable to alternative funds and non-redeemable investment funds (as the case may be) under NI 81-102. We submit that, in many cases, to require existing commodity pools and closed-end funds to reduce the level of leverage used will result in the investment strategies used by the fund becoming wholly ineffective and may require such funds to cease operations.

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. In particular, we recommend that the proposed amendments include a carve-out provision that would permit an alternative fund, in determining the aggregate gross exposure, 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. 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 proposed Companion Policy 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.

12. 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, given that the proposed amendments will permit an alternative fund to short up to 50% of its NAV, changes in the custodial provisions set out in Section 6.8.1 are necessary to alleviate 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.

We 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.

13. Parts 9 and 10

There is a need for Parts 9 and 10 to recognize that many alternative funds will allow purchases and redemptions on a weekly or monthly basis (that is, at the NAV of the Fund determined on the last day of a calendar week or month, for instance, provided the purchase order is received in advance of that applicable day). We point out that section 14.2(3) of National Instrument 81-106 Investment Fund Continuous Disclosure (NI 81-106) allows for weekly NAV calculations, but requires investment funds that use specified derivatives or engage in short sales to calculate NAV daily. Under the rules in Parts 9 and 10 of NI 81-102, the purchase or redemption price of a mutual fund security must be the next NAV determined after receipt of the applicable order. If a mutual fund is required to calculate NAV daily (as would be the case for many alternative funds), this

would create difficulties for funds redeemable on a weekly or monthly basis. We do not consider that new subsection 10.3(5) provides sufficient flexibility in this regard (this provision is intended to allow for additional – and different flexibility regarding payment out of redemption proceeds) and note that there is no such flexibility provided for in Part 9 (dealing with purchases).

We believe there is a simple drafting fix for both Parts 9 and 10:

> Despite subsection [insert the correct section reference] an alternative fund may implement a policy that a person or company making a purchase/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 purchase/redemption date of the alternative fund** ~~**first or 2nd business day**~~ after the date of receipt by the alternative fund of the purchase/redemption order.

We suggest that the CSA consider linking the weekly/daily NAV calculation requirements in NI 81-106 to the Companion Policy discussion about purchases and redemption orders and NAV for those purposes in NI 81-102.

14. Part 15

Section 15.6(1)(a) contains a prohibition against the inclusion of performance data in a 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 privately offered mutual fund (a pooled fund) with a suitable strategy that wanted to convert the pooled fund into a publicly offered alternative fund by filing a prospectus would not be able to include the historical track record of the pooled fund in sales communications pertaining to the alternative fund.

Given the unique nature of the proposed alternative fund changes, we strongly recommend that the CSA consider providing 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, particularly in the situation where the pooled fund complied with the new NI 81-102 regime in all material respects. Without this information, investors will not be able to obtain a full picture of the skill and abilities of the investment fund manager in carrying out the strategies of the specific fund. We consider this important information for investors and believe that appropriate caveats can be provided, that would allow investors to properly understand this information.

Comments on Fund Facts/Prospectus Disclosure – NI 81-101 and NI 41-101 Amendments

15. Under the proposed amendments, alternative funds will be required to include specified "text box" disclosure in Fund Facts or on the prospectus face page (as applicable) that, among other things, will require an explanation about the "specific strategies that differentiate this fund from conventional mutual funds" and "how the listed investment strategies may affect an investor's chance of losing money on their investment in the fund". We feel this text box disclosure is not necessary and could likely require lengthy explanations which will be at odds with the regulatory purpose of the Fund Facts/face page disclosure.

We strongly recommend that the only relevant information (which may not even be that relevant given the other disclosure that will be in the Fund Facts or the long form prospectus), is a simple statement that "this mutual fund is an alternative fund. It has the ability to invest in asset classes or use investment strategies that are not permitted for conventional mutual funds. Please read the details of this fund's investment objectives and strategies carefully and ask your advisor for more information as to how this fund will help you achieve your investment goals".

Anything else would be too long, duplicative and potentially meaningless for investors – particularly in a Fund Facts document or face page disclosure that is designed to be concise and simple.

We particularly take issue with the notion that alternative funds' strategies may "affect investors' chance of losing money on their investment in the alternative fund". This type of dire warning was included in "commodity pool" prospectuses, but the effectiveness of this disclosure, when considered in the context of modern-day alternative funds and the Fund Facts/ prospectus disclosure is not appropriate. We note also that requiring this disclosure for alternative funds but not more generally to non-redeemable investment funds appears to suggest that somehow alternative funds will be more likely to "lose money", whereas non-redeemable investment funds are not. Also, it suggests that alternative funds are inherently more risky than conventional funds or closed-end funds, when this is not necessarily the case. We do not consider this distinction to be appropriate.

Comments on Transition

16. The CSA propose that any new rules will come into effect three months after publication date for the final rules, and that a further six months be provided to allow existing funds to change their affairs so as to comply with the new rules. We are not entirely certain that the suggested transition of the CSA works or is really necessary.

(a) **Some form of "grandfathering" will be necessary for existing commodity pools and closed-end funds as we recommend in our comment 11.**

(b) Otherwise, since there are not many commodity pools in existence, we recommend that the CSA simply permit existing commodity pools to continue with their prospectuses and operations – and make all amendments to their strategies (as required) and disclosure at their next renewal date, so long as that date is not within the 3 month transition period. Some timing considerations by the CSA would be considered very useful for existing commodity pools (i.e. allowing them to operate under the "old" regime until their next renewal time). It is not optimal for funds to have to file amended documents (which would be completely different – i.e. moving from a "long form" prospectus to the NI 81-101 requirements) mid-year or before the next renewal.

(c) The above-noted transition should also apply to closed-end funds that already have a prospectus and are reporting issuers (assuming they are in continuous distribution).

(d) Commodity pools and closed-end funds that do not wish to comply with the new regime, should be given a sufficient period to continue their operations, so long as no new sales are permitted after the lapse of one year (for instance) after the effective date of the new rules, so as to allow for an orderly wind-down of their operations or taking these vehicles private.

(e) Any current "private" fund that wishes to become a public reporting issuer (alternative fund) should be required to comply with the new requirements (i.e. change their affairs to become compliant) and file a preliminary prospectus under NI 81-101, which they can do at any time after the rules become effective.

(f) If any publicly offered mutual fund wishes to become an "alternative" fund, it will be required to adopt different investment strategies (and potentially investment objectives), which may take some time to implement. It would be appropriate for those funds to file an amended and restated prospectus with full compliance with the new requirements, if they wish to become an "alternative fund" before their next renewal.

Comments on Risk Classification Challenges

We understand that there will be challenges for alternative funds to comply with the new risk classification rules that were published in final form on December 8, 2016 and urge the CSA to consult further with the industry on this point. It may be that these amendments to NI 81-102 should include revisions to the risk classification rules to allow alternative funds to be able to calculate and disclose risk.

We thank you for considering our comments. Please contact any of the undersigned if you would like additional information or wish us to elaborate on our comments. We, together with others at our firm who have considered the proposed amendments, would be very pleased to meet with you.

Yours very truly,

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