December 22, 2016

BY EMAIL

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 Consumers 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

The Secretary
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Toronto, Ontario
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– and –

Me Anne-Marie Beaudoin, Corporate Secretary
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Dear Sirs/Mesdames:

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

The Canadian Advocacy Council[1] for Canadian CFA Institute[2] Societies (the **CAC**) appreciates the opportunity to provide the following general comments on the Notice and respond to the specific questions referenced below.

As a general comment, while we appreciate the opportunities that may be presented to mutual fund managers to broaden their investment strategies, we wish to emphasize our general concern that the proposals may result in very complex strategies being introduced to the retail market, while no specific or related proficiency requirements relating to dealers selling these products are currently being

[1] The CAC represents more than 15,000 Canadian members of the CFA Institute and its 12 Member Societies across Canada. The CAC membership includes portfolio managers, analysts and other investment professionals in Canada who review regulatory, legislative, and standard setting developments affecting investors, investment professionals, and the capital markets in Canada. See the CAC's website at http://www.cfasociety.org/cac.

[2] CFA Institute is the global association of investment professionals that sets the standard for professional excellence and credentials. The organization is a champion for ethical behavior in investment markets and a respected source of knowledge in the global financial community. The end goal: to create an environment where investors' interests come first, markets function at their best, and economies grow. CFA Institute has more than 135,000 members in 151 countries and territories, including 128,000 CFA charterholders, and 145 member societies. For more information, visit www.cfainstitute.org.

proposed. Given the complexity and potential risks of these products, we believe strongly that MFDA and IIROC dealer members wishing to transact in these products should, at a minimum, be required to have training to emphasize the differences between conventional mutual funds and alternative mutual funds, and the risks thereof.

We wish to stress the importance of the CSA implementing a regulatory best interest standard on all persons providing investment advice, which would help ensure that any recommendation under the proposed regime to buy an alternative mutual fund is in fact in a client's best interest. In the absence of such a standard, we have concerns about the appropriateness of some of the contemplated permitted strategies for the retail market under the proposal as more specifically addressed below.

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?*

   We are of the view that the term "alternative fund" is not an ideal choice, as the term is already used in the market to broadly refer to investment funds distributed under an exemption from the prospectus requirements (also commonly referred to as "hedge funds", "private equity funds", etc. in the exempt market). The confusion that might otherwise result will be particularly acute for investors in funds managed/advised by advisers that also distribute such exempt products. As a result, we prefer the term "alternative mutual fund" as it clarifies that the fund is a type of mutual fund, which is a well identified category, and is consistent with the language used in other jurisdictions, notably the United States under the '40 Act liquid alternatives regime.

   Investor education will be important to help them appreciate the true nature of these funds, their unique and non-homogeneous return and risk characteristics (depending on the investment strategies being employed), and be in a better positon to compare them to other mutual funds having different characteristics.

   We thus support the proposed requirements for funds to provide investors with meaningful and prominent disclosure of the key investment objectives, description of strategies and risks in their disclosure documents and for alternative mutual funds to highlight for investors in a prominent manner the extent to which the fund's investment restrictions and strategies may differ from those used by conventional mutual funds.

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.*

   We encourage the CSA to consider including an exemption to permit alternative mutual funds to invest in non-guaranteed mortgages and loan syndications/participations. Specifically, we recommend that alternative mutual funds be exempted from the restrictions in paragraphs 2.3(b) and (c) of NI 81-102 to permit alternative funds to invest up to 10% of their net asset value in non-guaranteed mortgages and an unlimited amount in guaranteed mortgages. We also recommend that alternative funds be exempt from paragraph 2.3(i) of NI 81-102 to permit alternative funds to invest up to 100% of their net asset value in loan syndications or loan participations (without regard to whether the fund would assume any responsibilities in administering the loan). These exemptions would enable alternative funds to provide retail investors with loan and mortgage fund solutions that currently are available only on an exempt market/private placement basis, and we do not believe that all of these types of investments are *de facto* inconsistent with the passive investment nature of a mutual fund, particularly if they are arm's length investments.

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.*

   As a general comment, we note that concentration risk in isolation is not informative, and may oversimplify the risk associated with additional asset classes contemplated under the proposal. For example, a 20% position in a portfolio comprised of large-cap, liquid public equities is not the same as a 20% position in the equity of an unknown, tightly-held, and illiquid recently listed venture issuer. As another example of our concern regarding the use of concentration risk in isolation, if a portfolio manager could take a large position in a security (e.g. equity in a Canadian bank) and enter into a hedge using a swap agreement, there will be no change to the percentage concentration of the fund's investment in that security, but it could have a significant impact on the fund's exposure to that issuer.

   As a result, we do not agree that alternative mutual funds should be permitted to exceed the current 10% issuer concentration limit contained in NI 81-102. As an alternative, if the limits do increase, as an additional control, alternative mutual funds could be limited to investing no more than 50% of their net asset value, in aggregate, in holdings that individually exceed 10% of the fund's net asset value. We do not believe an upper limit, or "hard cap" on the concentration restrictions is ideal for alternative funds, as it could result in a forced sale of assets in distressed situations to create liquidity.

   Increased limits to concentration restrictions, in general, may only be appropriate for certain asset classes with sufficient liquidity to readily satisfy daily redemption requests.

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.*

   The limit on illiquid assets, and liquidity generally of the underlying portfolio, should be tied to redemption frequency of the alternative mutual fund. If redemptions were permitted on a weekly or (ideally) more infrequent basis, the illiquid asset limit for alternative funds could conceivably be increased relative to the current restrictions to mirror the proposed restriction on non-redeemable investment funds.

   We note that the CSA should consider revisiting the definition of an illiquid asset such that it is more risk-based. As another general comment, and as reflected in our response to Question

#3 above, the concentration risk must be linked to the liquidity risk of the portfolio's security holdings. The more complex the strategy and the linkages between securities in the portfolio, the harder it is to look at one metric in isolation.

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.*

   Please see response to question #4 above. A cap may not be required for non-redeemable funds, provided annual liquidity can be managed in the context of the liquidity of the underlying investment portfolio.

6. *We are also proposing to cap the amount of illiquid assets held by a non-redeemable investment fund, at 20% of NAV at the time of purchase, with a hard cap of 25% of NAV. We seek feedback on whether this limit is appropriate for most non-redeemable investment funds. In particular, we seek feedback on whether there are any specific types or categories of non-redeemable investment funds, or strategies employed by those funds, that may be particularly impacted by this proposed restriction and what a more appropriate limit, or provisions governing investment in illiquid assets might be in those circumstances. In particular, we seek comments relating to non-redeemable investment funds which may, by design or structure, have a significant proportion of illiquid assets, such as 'labour sponsored or venture capital funds' (as that term is defined in NI 81-106) or 'pooled MIEs' (as that term was defined in CSA Staff Notice 31-323 Guidance Relating to the Registration Obligations of Mortgage Investment Entities).*

   Please see out response to Question #3 above which would necessitate a higher limit for mortgage investments.

7. *Although non-redeemable investment funds typically have a feature allowing securities to be redeemable at NAV once a year, we also seek feedback on whether a different limit on illiquid assets should apply in circumstances where a non-redeemable investment fund does not allow securities to be redeemed at NAV.*

   We are of the view that a higher limit for these limited circumstances is not warranted, as it might inadvertently result in the offering of additional products which do not contain a redemption feature which may be not be appropriate for many retail investors.

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.*

   We would like to see alternative mutual funds in Canada be allowed to borrow from foreign banks (under equivalent foreign regulatory regimes to that which exist in Canada for permitted counterparties) and their affiliated dealers that offer prime brokerage services. A broader range of prime brokers would significantly improve the competitive landscape in Canada and enable Canadian investment managers to seek better borrowing/financing terms.

   With respect to borrowing securities on the short side under a margin agreement, our understanding is that typically, borrowings are from the inventory of investment dealers and their correspondent borrowing network/relationships. Managers that employ certain strategies (e.g. Japanese long/short fund) may not necessarily have access to the best rates and services from dealers in Canada simply because they do not hold sufficient inventory of or have access to via local relationships the requisite global securities.

As a more general comment, counterparty exposure should be measured across the board, on a net basis, and not just with respect to the use of specified derivatives.

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.*

   A number of alternative strategies may not be possible or optimally implemented under this restriction, such as fixed income arbitrage funds that may be interested in hedging different sources of risk inherent in investing in the bond market including interest rate risk, credit risk or yield curve risk. Should these funds (e.g. fixed income arbitrage) choose to enter into multiple hedging instruments such as interest rate swaps or futures, they may not be able to fully execute their investment strategies due to the proposed leverage limit and calculation methodology. In general, any type of arbitrage fund could also be impacted as such funds generally require leverage to implement their strategies and achieve their target returns. Other strategies that could be impacted include credit and distressed strategies, event-driven strategies, volatility strategies, and tail risk funds.

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?*

    Alternative mutual funds should be permitted to include offsetting or hedging transactions to reduce their calculated leveraged exposure. We disagree with including notional amount in the definition of leverage if those derivative transactions are used to reduce the overall risk exposures or volatility of the portfolio. We believe that the intent of limiting funds' leverage is to limit the risks that investors may be exposed to when market events work against the investment strategy. As a result, transactions that are used to hedge portfolio market exposure should not be included in the calculations or be calculated on a net basis.

    Offsetting or hedging transactions could be used to reduce a fund's calculated leverage exposure. We support the leverage calculation known as "the committed method" as set out in Article 8 of the Official Journal of the European Union, Section 2: Calculation of Leverage. According to this Article, to calculate the exposure of an alternative investment fund ("AIF") in accordance with the commitment method, the manager shall:

    a) convert each derivative instrument position into an equivalent position in the underlying asset of that derivative using the conversion methodologies set out in Article 10; and
    b) apply netting and hedging arrangements.

    For the purposes of calculating the exposure of an AIF according to the commitment method:

a) Netting arrangements shall include combinations of trades on derivative instruments or security positions which refer to the same underlying asset irrespective – in the case of derivative instruments – of the maturity date of the derivative instruments and where those trades on derivative instruments or security positions are concluded with the sole aim of eliminating the risks linked to positions taken through the other derivative instruments or security positions.

b) Hedging arrangement shall include combinations of trades on derivative instruments or security positions which do not necessarily refer to the same underlying asset and where those trades on derivative instruments or security positions are concluded with the sole aim of offsetting risks linked to positions taken through the other derivative instruments or security positions.

Alternative funds could be allowed to net positions between derivative instruments, provided they refer to the same underlying asset, even if the maturity date of the derivative instruments is different (within reason).

As a general comment, we note that the appropriateness of a hedge is difficult to identify in alternative portfolios, as hedging is non-standard, complex, and subjective. It can be difficult to determine how much exposure to an underlying asset or specific risk is in a derivative, subject to significant estimation or model risk in certain instances.

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.*

We agree with the statements provided in your question; it is difficult to measure the risk of a derivative instrument, and even more difficult to explain that risk to an investor. There are a number of derivative strategies that are used to offset portfolio risks and do not add to its overall risks or market exposure. Therefore, one suggested option to improve the leverage measurement methodology is to simply exclude the hedging transactions from the leverage calculation. This way, the investors would know exactly how much 'additional' net market exposure they are getting from an alternative mutual fund. For example, if a fund that follows the Universe Bond Index has 2x leverage, that means that this fund would be twice as exposed to a rising interest rate event compared to a conventional mutual fund that follows the same strategy, everything else being equal. Another way to measure the total risk of the fund resulting from the use of 'effective' leverage is to apply a variance-based measure such as VaR (value at risk). By comparing VaR between two funds, investors can see a direct contrast of their market risk levels, all estimation inputs being equal. We support the consideration of leverage calculation known as "the committed method" as described in our response to Question #10 above. In general, we would emphasize that risks in the alternative strategy universe are difficult to measure exactly, are subject to estimation error, and are inherently very difficult to fully communicate to all but the most sophisticated of investors.

Disclosure

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.*

    Please see our response to Question #14 below. We note that for many alternative mutual funds, there may not be an appropriate benchmark for comparison purposes. As a general comment, we believe that given the complexity and many additional risks that alternative strategies and leverage introduce, the current form and required content of the Fund Facts may not be appropriate if the intent is fulsome disclosure, comprehension for investors and ease of comparison to other mutual funds.

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?*

    The use of standard deviation alone as a volatility and risk measurement metric is not, in our view, sufficient, particularly where an alternative mutual fund under the proposal has not been in existence long enough for that track record to have any statistical meaning or where the volatility of a benchmark is substituted and may not properly represent the volatility or other risks of the mutual fund in question. A broader problem is that many alternative strategies contemplated under the proposal may inherently carry non-linear or asymmetric risks as part of their investment strategy, none of which can be adequately described by standard deviation in isolation.

    Further, investors usually perceive risk as the combination of the totality of risks affecting their portfolio, including risks other than volatility risk. As we have stated in previous comments relating to conventional mutual funds, but particularly applicable here, the potential downside to a mutual fund investment may in fact be greater than that indicated by normal historical volatility.

    While standard deviation is an informative measure, it is not a complete measure of risk in any investment situation, and as has been highlighted above, it can mask risks that arise as a result of the complexity of an investment product. As an illustrative example, a short-term fixed income mutual fund could have very low historical volatility over the measurement period in question, but be quite risky as a result of the complexity of the fund's underlying investments, some of which could have very asymmetric risk profiles in the event of a credit event, liquidity issues, or an interest rate shock. The risk rating of the fund, based on standard deviation, would have given the investor no insight into the asymmetric risk profile and complexity of the fund's investments. The Journal of Finance published a paper [A Risk and Complexity Rating Framework for Investment Products] (Koh et al.) discussing a complexity rating framework, which would help inform and augment traditional risk ratings. The paper describes other vectors that could be considered for risk measurement and required mutual fund disclosures in future projects. Another consideration is that standard deviation is an unreliable risk metric to use with respect to alternative mutual funds because these funds may employ illiquid or infrequently priced securities such as physical commodities, OTC derivatives, or mortgage investments. Infrequent pricing of these illiquid instruments can conceal the true risk exposure by lowering the standard deviation and risk rating for the fund, which in turn exposes the retail investor to unintended risks and potential negative consequences.

Point of Sale

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.*

    The challenge of delivering point of sale disclosure associated with the sale of alternative mutual funds likely lies in the additional complexity of these types of products. Our view is that this does not necessarily create a comparatively greater expense when compared to conventional mutual funds, although we suspect it will take longer to explain the additional / unique risks. It does require that those selling the products are appropriately informed to deliver point of sale disclosure and address questions and concerns from potential investors in these types of products, the expense of which is necessary from an investor protection standpoint.

    As an example, in our answer to Question #14 we discussed whether risk measures expected to be included in Fund Facts disclosures were valid in the context of alternative mutual funds. Certain risk measures (like volatility) require significant education to understand and then apply in an investment context. Explaining the usefulness of this measure in an alternative mutual fund may require that one also explains the shortfalls of this risk measure when applied to non-traditional asset classes (ie. illiquid investments).

    Consequently, it is important that those delivering point of sale disclosure are appropriately educated to explain the disclosures as they relate to the specific products.

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.*

    As a general concept, the proposed period should be sufficient to allow existing funds to transition to the updated regulatory regime. We do raise, for consideration, that different aspects of the Proposed Amendments may require separate timelines for implementation.

    One such example might be concentration limit changes, which should be implemented prospectively to prevent funds that have been invested appropriately given current regulation from implementing changes that come at a cost to investors (ie. selling down an illiquid concentrated position at a loss). Conversely, point of sale disclosure for alternative mutual funds should be implemented in an orderly fashion if it is decided that investors could benefit from these disclosures.

A proposed timeline may benefit from further consultation with industry participants before finalizing the Modernization Project.

Concluding Remarks

We thank you for the opportunity to provide these comments. We would be happy to address any questions you may have or to meet with you to discuss these and related issues in greater detail. We appreciate the time you are taking to consider our points of view. Please feel free to contact us at chair@cfaadvocacy.ca on this or any other issue in future.

(Signed) *Michael Thom*

Michael Thom, CFA
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