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FUND MANAGEMENT INC.

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British Columbia Securities Commission
Financial and Consumer Affairs Authority of Saskatchewan
Ontario Securities Commission
Financial and Consumers Services Commission, New Brunswick
Nova Scotia Securities Commission
Registrar of Securities, Northwest Territories
Superintendent of Securities, Nunavut
Alberta Securities Commission
Manitoba Securities Commission
Autorité des marchés financiers
Superintendent of Securities, Department of Justice and Public Safety, Prince Edward Island
Securities Commission of Newfoundland and Labrador
Registrar of Securities, Yukon Territory

Attention:

The Secretary
Ontario Securities Commission
20 Queen Street West
22nd Floor
Toronto, Ontario M5H 3S8
Fax: 416-593-2318
Email: comments@osc.gov.on.ca

Corporate Secretary
Autorité des marchés financiers
800, square Victoria, 22e étage
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Montréal (Québec) H4Z 1G3
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E-mail: consultation-en-cours@lautorite.qc.ca

Dear Mesdames/Sirs:

Re: Comments on the Canadian Securities Administrators' (the "CSA") Proposals for the Modernization of Investment Fund Product Regulation – Alternative Funds

We are writing to provide our comments to the *CSA Notice and Request for Comment - Modernization of Investment Fund Product Regulation – Alternative Funds* dated September 22, 2016 which set out proposed amendments to National Instrument 81-102 *Investment Funds* ("**NI 81-102**"), Companion Policy 81-102CP *Investment Funds*, the repeal of National Instrument 81-104 *Commodity Pools* and related consequential amendments (the "**Proposed Amendments**").

East Coast Fund Management Inc. ("**East Coast**" or "**we**") is a 100% employee owned Portfolio Manager, Investment Fund Manager, Commodity Trading Manager and Exempt Market Dealer that has approximately $400 million of assets under management. We act as manager and/or portfolio advisor for a number of investment funds offered in the exempt market, as well as sub-advise conventional mutual funds ("**CMFs**") and a non-redeemable investment fund (commonly known as closed-end funds ("**CEFs**")), all of which have investing strategies that focus on fixed-income solutions that seek to hedge away interest rate risk and other specific risks. We believe our experience managing/sub-advising the same or similar investment strategies across this breadth of fund types, gives us a unique perspective on how the investment restriction regimes applicable to each type of investment fund impacts the performance, risks, and expenses of each particular fund category noted above.

The undersigned have collectively more than 65 years of combined domestic and international experience in the financial services industry in various trading, compliance and senior management roles for leading Canadian investment dealers. This collective experience includes most notably, Michael MacBain's tenure as President of TD Securities Inc. as well as Sinan Akdeniz's experience as a senior executive at TD Securities Inc. and as a Commissioner at the Ontario Securities Commission. With this letter, we hope to provide focused and specific comments related to the investment strategy and investment risk aspects of the Proposed Amendments.

General Comments

We welcome and support the introduction of "Alternative Funds", within the NI 81-102 regime as a new category of investment funds. The introduction of Alternative Funds will give portfolio managers like us the ability to offer hedged or risk-adjusted products to retail investors that will be redeemable at NAV. This will offer investors access to strategies, previously not available, which will help reduce risk and diversify returns. We believe our investing solutions lend well to this new type of investment fund and we anticipate creating and offering Alternative Funds ourselves or with our industry partners should the framework allow for the flexibility to offer our strategy.

Specific Comments and Concerns

Although encouraged by the possible introduction of Alternative Funds, we do have a number of significant concerns regarding the impact the Proposed Amendments will have on existing CMFs and CEFs. We would also like to provide some suggestions on how to improve the design of some of the proposed investment restrictions applicable to Alternative Funds.

Short Sales (Section 2.6.1)

The Proposed Amendments would subject Alternative Funds and CEFs to the same short selling limits (i.e. issuer-level shorting limit of 10% of NAV and aggregate fund-level shorting limit of 50% of NAV). In respect of both types of funds and both limits, we believe it is essential that short positions entered into for hedging purposes be netted out, set-off or excluded from the calculation when calculating these limits. From our perspective, we think that allowing a fund to exclude short positions entered into or maintained for hedging purposes from the calculation of these limits is the most appropriate approach. Particularly for our fixed-income hedged investment strategy, the short positions benefit investors directly by reducing risk and protecting capital (i.e. hedge interest rate risk associated with the corporate bonds purchased). NI 81-102 already includes a number of exceptions or special treatment for hedging transactions. We believe short sales for hedging purposes should receive the same treatment by excluding them from the determination of any short selling limits under the Proposed Amendments.

We recognize that not all short sales are a perfect hedge for the long position they are intended to hedge. To address this, we believe that the language in NI 81-102 can be kept simple by having language that excludes short sales entered into for hedging purposes, and the Companion Policy can specify that the quantum of the short position that can be excluded from the calculation is the quantum that the manager has reasonable grounds to believe will offset the price changes in the applicable long position(s).

Even with short sales for hedging purposes excluded, as a sub-advisor to both CEFs and CMFs, we think that the structure, offering process and features of CEFs are distinctly different from CMFs and Alternative Funds, and such differences should result in separate limits with respect to short sales. CEFs trade on an exchange and are redeemable at NAV far less frequently than CMFs and Alternative Funds. This provides a portfolio manager greater certainty regarding the stability of the asset base being managed. This added certainty allows the portfolio manager to enter into long and short positions with confidence that they will not have to unwind or liquidate positions to fund redemptions. Furthermore, CEFs are offered only through IIROC registered dealers (i.e. not available through the MFDA network). IIROC registered dealers are subject to higher education and proficiency requirements and are better able to understand and explain an investing strategy that involves short selling to clients. We believe that the certainty of the asset base and a more educated dealer network justifies CEFs having higher shorting limits than Alternative Funds. Instead of the 50% of NAV limit that is proposed for Alternative Funds, we are of the view that CEFs should have a limit of 100% of NAV (along with the ability to exclude short positions used for hedging mentioned above).

Leverage Limit re: Short Sales (Section 2.9.1(2)(b))

Generally speaking, leverage is seen to enhance performance, but also increase risk and magnify losses. Shorting securities is a common method used to create leverage as shorting securities is a source of cash, and that cash can be used by a portfolio manager to invest in other assets. However, we believe that when shorting is done for hedging purposes, the effect and risks are very different and warrant different treatment.

An example may be the best way to illustrative this point.

A Fund Shorts For Non-Hedging Purposes	**A Fund Shorts For Hedging Purposes**
• The fund starts with $100 cash • The fund shorts $50 of government bonds • The fund now has $150 of investible cash. • The fund buys a basket of mining stocks using $150 of cash • The fund posts the $150 stock basket as collateral against the short position (collateral value of 70% of $150) • The fund's full $150 portfolio is exposed to the performance of the mining stocks and the appreciation in the value of the bonds they shorted (which do not have a strong correlation). In other words, the performance of the basket of mining stocks and the short government position could go in opposite directions both leading to losses. • In this scenario, the shorting of the government bonds increased the assets of the fund (e.g. true creation of	• The fund starts with $100 cash • The fund shorts $100 of government bonds • The fund buys a basket of corporate bonds using $100 of cash • The Fund posts the corporate bond portfolio as collateral against the short position (collateral value of $98. The collateral requirement is $102 so $4 is required from the cash portion of the portfolio) • The fund is long $96 of cash, long $100 of corporates bonds, short $100 of government bonds and has posted $4 in collateral • The short government bond position and the long corporate bond positions have a high inverse correlation in price movement (of approximately 0.7). In fact, since corporate bonds are quoted as a spread over government bonds, the two instruments have a 100% inverse correlation

assets/leverage), increased the risk of the fund and the short position did not provide any downside protection We believe imposing a specific shorting limit and including a shorting component to an aggregate leverage limit is warranted for **non-hedging purposes** to protect investors from excessive leverage and risk.	with respect to movements in interest rates. In this instance, although the short position is twice as much as the short position in the example used for Non-Hedging purposes, the $100 short government bond position acts as an interest rate hedge thereby reducing the overall risk in the corporate bond portfolio and therefore the risk to the end investor. We believe this comparative example demonstrates why any limit with respect to short selling should exclude short positons for hedging purposes.

Leverage Limit re: Specified Derivatives (Section 2.9.1(2)(c))

We believe that not being able to exclude, net out or set-off specified derivatives used for hedging purposes, along with the use of "the aggregate notional amount", when determining a fund's use of specified derivatives and leverage limit fails to acknowledge the benefits of hedging strategies for reducing the overall risk of an investment strategy. Similar to short sales entered into for hedging purposes, specified derivatives entered into for hedging purposes should be netted out or set-off or at the very least be adjusted for when determining leverage limits under the proposed Section 2.9.1.

We believe that for the purposes of Section 2.9.1(2)(c), either a fund should be able to net out or set-off specified derivative positions entered into or maintained for hedging purposes or the concept of "maximum loss" should be used to determine the risks and limits of specified derivatives.

The concept of maximum loss and the issues caused by using "aggregate notional amount" are perhaps best illustrated with an example.

1. A fund with $100 NAV writes a $100 at-the-money put on Royal Bank and receives a $2 premium back from the purchaser. The notional value of the put the fund wrote is $100, representing 100% of the NAV of the fund.
2. To protect the downside risk of the put it wrote, the fund buys a $90 out of the money put on Royal Bank for $1. The notional value of the put it purchased is $90.
3. The NAV of the fund is $100, but the aggregate notional value of its specified derivatives is $190, representing 190% of NAV.
4. However, because the $90 put the fund bought is a hedge against the $100 put the fund wrote, the "maximum loss" the fund could suffer is $10. It is the $10, being the result of netting the specified derivatives that is relevant for determining the fund's exposure and risk, not the notional amount of the specified derivatives ($190).

To take the above example one step further, under the current formulation of Section 2.9.1, in addition to the above trade, if a fund entered into the same or similar transaction in respect of BCE at $60 (write put) and $50 (buy put), and CIBC at $110 (write put) and $100 (buy put), the fund's specified derivatives would have an aggregate notional amount of $510, representing 510% of its NAV, thereby violating the maximum aggregate leverage limit in the Proposed Amendments of three times NAV. But, the fund's maximum loss would only be $30. This is just one simple illustration of why we believe that specified derivatives used for hedging purposes should be netted out or set-off when determining any leverage limit.

As illustrated in the above example, when specified derivatives are entered into for hedging purposes, the aggregate notional amount of the positons is an irrelevant and misleading measurement to assess and limit risk. That said, we appreciate that specified derivatives are inherently leveraged instruments. But when used to hedge another specified derivative and/or an underlying position in a fund, the notional values of the two specified derivatives and/or the notional value of the specified derivative and the actual value of the underlying positions should be set-off or netted out when determining any leverage limits for the fund. We believe that either: (i) the concept of "maximum loss" should be used when measuring specified derivatives contribution to any leverage limit of CMFs, Alterative Fund and CEFs; and/or (ii) the concept of "maximum loss" should be used to assess the risk and set prescribed limits for specified derivatives.

To leave Section 2.9.1 as currently proposed with "the aggregate notional amount" and no adjustment for hedging positions will actually limit the ability to protect investor capital and would have serious consequences to existing CMFs, seriously restrict strategies of Alternative Funds and could impact the strategies of a number of existing CEFs.

Leverage Limit re: Generally

Section 2.9.1 has broad application. It applied to CMFs, Alternative Funds and CEFs. As currently proposed, it sets an aggregate leverage limit of three times NAV and sets out the methodology for calculating the limit. We find it interesting that borrowing and short sales each have their own 50% NAV limit, and also have an aggregate borrowing and short selling limit of 50% of NAV.

We fail to see why having an aggregate three 'buckets' approach to measuring maximum leverage, while also having smaller individual limits and group limits on shorting and borrowing, helps to reduce risk or provide better investor protection. Many, portfolio managers run investing strategies that employ one principal form of leverage, not a cross section of multiple forms of leverage. Introducing a compartmentalized aggregate leverage limit may have the unintended consequence of forcing portfolio managers to use alternative forms of leverage that are not a fit for the strategy or forms they are less familiar with. We do not see this as a good thing.

Borrowing vs Short Selling

We understand the need to limit "cash" borrowing under proposed Section 2.6(2), as cash borrowing is true leverage where a fund takes on a liability to create new assets that the portfolio manager can use to deploy in investment instruments as they see fit. We fail to see the rationale of treating cash borrowing and short selling as being the same and subjecting them to the same limit, as currently proposed in Section 2.6.2. The differences between cash borrowing and short selling are particularly acute when short selling is done for hedging purposes. Short selling for hedging purposes links the liability taken on by the fund (i.e. the short position) with the asset acquired under the strategy (i.e. the long position obtained), thus reducing risk. The same is not true for cash borrowing. The liability taken on by the fund (i.e. obligation to repay cash) is not linked to the risk or return of the assets acquired. Even if the cash borrowed is used to hedge a risk the fund is exposed to, the obligation to repay the cash is independent of the (hedged) return of the fund. We believe that the differences between the use and risks associated with cash borrowing versus short selling, whether for hedging or non-hedging purposes, necessitates separate treatment.

Specifically:

- The 50% limit in proposed Section 2.6.1(1)(v) should allow for netting out or exclude short positions entered into for hedging purposes.

- The total borrowing and short selling limit in proposed Section 2.6.2 applicable to CMFs, Alternative Funds and CEFs should not aggregate borrowing and short selling. Borrowing and short selling should just be subject to separate and distinct limits. The use of borrowing by a fund should not cut into availability of shorting by the fund, particularly if the shorting is being done for hedging purposes. As such, we think that aggregate borrowing and shorting limits in Section 2.6.2 should be decoupled and that any limit applicable to short selling should allow for netting out or exclude short positions entered into for hedging purposes.

Conclusion

We are encouraged that the CSA has recognized that Alternative Funds play an essential and crucial role in product selection for investors. By making these types or solutions accessible, investors will benefit from the risk reducing and return diversification nature of these strategies. Thank you for the opportunity to provide these comments. We would be pleased to discuss any of the foregoing matters outlined in this letter. Do not hesitate to contact us.

Sincerely,

"Mike MacBain"	*"Sinan Akdeniz"*	*"Michael D'Costa"*
Mike MacBain CEO & Chief Investment Officer	Sinan Akdeniz President & Chief Risk Officer	Michael D'Costa CCO & Chief Operating Officer