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Reply to the Attention of	Margaret McNee
Direct Line	416.865.7284
Email Address	Margaret.McNee@mcmillan.ca
Our File No.	99999
Date	December 22, 2016

Delivered By Email: 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
Authorité des marches 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

Attention:

The Secretary
Ontario Securities Commission
20 Queen Street West
22nd Floor
Toronto, Ontario 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 (Québec) H4Z 1G3

Dear Sirs/Mesdames:

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

We are writing in response to the Proposed Amendments and the CSA request for comments. At McMillan LLP, we have an *Investment Funds and Asset Management* practice group that has expertise in structuring, registration, compliance, tax, derivatives, sales and marketing, continuous disclosure, listings and ongoing operations for the investment fund and asset management industry. We have participated in a number of industry comment letters on the Proposed Amendments. For the purposes of this comment letter, we have responded to certain of the specific questions posed by the Notice and Request for Comment (Annex A) and have reproduced those questions for ease of reference alongside the general themes identified by the CSA. We have also provided additional comments on the Proposed Amendments for your consideration at the end of this letter.

1. Illiquid Assets

Q5: Should we consider how frequently an alternative fund accepts redemptions in considering an appropriate illiquid asset limit? If so, please be specific. We also seek feedback regarding whether any specific measures to mitigate the liquidity risk should be considered in those cases.

Response:

We would like to take this opportunity to bring the CSA's attention the discrepancy between the regime for purchases and redemptions of alternative funds under the Proposed Amendments and the requirements to calculate net asset value ("**NAV**"). Under the current regime in Section 14.2(3) of National Instrument 81-106 *Investment Fund Continuous Disclosure* ("**NI 81-106**"), investment funds are required to calculate NAV weekly, unless they use specified derivatives or short sales, in which case they are required to calculate NAV daily. Pursuant to Section 10.3 of NI 81-102, upon redemption, the redemption price of a security must be the next NAV determined after receipt of the redemption order. When the "next NAV determined" is the NAV on the next business day (as would be the case for many alternative funds since they use specified derivatives) real valuation and timing difficulties are created for funds redeemable on a weekly or monthly basis.

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

A similar problem exists for purchases of securities of an alternative fund under the Proposed Amendments. Pursuant to Section 9.3 of NI 81-102, the issue price of a security of a mutual fund must also be the next NAV determined after receiving the purchase order. In this case however, the carve-out provided for redemptions described above does not exist.

We acknowledge that the Proposed Amendments do not prescribe any particular redemption frequency for alternative funds. However, the obvious problem for alternative funds offering weekly or even monthly purchases and redemptions as of a specific day is that they will have to use multiple issue and redemption prices on any particular purchase or redemption date because they will be calculating NAV on a daily basis and could potentially receive orders every day of the week. In the extreme example, an alternative fund with monthly redemptions may be required to issue or redeem securities at up to 30 different NAVs on the same purchase or redemption date.

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

> "(5) Despite subsection (1) an alternative fund may implement a policy that a person or company making a redemption order for securities of the alternative fund will receive the net asset value for those securities determined, as provided in the policy, on the **next redemption date of the alternative fund** after the date of receipt by the alternative fund of the redemption order.

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

Q7: 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.

Non-redeemable funds are designed to allow investment in less liquid assets as a result of not facing daily or periodic redemptions. As noted by the CSA, most non-redeemable investment funds primarily offer liquidity through listing their securities on an exchange. As investors do not expect liquidity in these funds, introducing a limitation for investment in illiquid assets during the life of the fund does not provide additional protections to an investor and may result in increased costs. There has always been a strong connection between liquidity and redemption. A consultation report dated April 26, 2012, on liquidity risk management of the International Organization of Securities Commissions by the Technical Committee outlined guidance to entities responsible for the overall operation of collective investment schemes. The second principle referenced for liquidity risk management was that a "*responsible entity should set appropriate liquidity thresholds which are proportionate to the redemption obligations and liabilities of the [collective investment schedule]*". In the case of non-redeemable investment funds, there are few redemption obligations, if any.

Notwithstanding the foregoing, to the extent the CSA feels that a limitation must exist for the illiquid assets held by a non-redeemable investment fund, we recommend that a limitation of 25% of NAV in illiquid assets be introduced six months prior to the expected termination date of the fund.

2. Total Leverage Limit

Q9: Are there specific types of funds, or strategies currently employed by commodity pools or nonredeemable investment funds that will be particularly impacted by the proposed 3 times leverage limit? Please be specific.

Response:

There are no limitations on the aggregate notional exposure under specified derivative transactions under the current regime applicable to commodity pools. We understand that many existing commodity pools may not be able to comply with the 300% leverage limit on the notional value of derivatives used by the commodity pool. As the investment strategies of these existing funds were established to comply with the current regime, and investors invested in the commodity pools on that basis, we recommend that these commodity pools be grandfathered and permitted to continue to operate under an exemption from the 300% leverage limit in the Proposed Amendments subject to complying with the other requirements applicable to alternative funds under NI 81-102. We submit that, in many cases, to require existing commodity pools to reduce the level of leverage used will result, contrary to the expectations of investors in the investment strategy used by the pool becoming wholly ineffective and requiring such commodity pools to cease operations. Please see our comments below under 5. Transition.

Q10: The method for calculating total leverage proposed under the Proposed Amendments contemplates measuring the aggregate notional amount under a fund's use of specified derivatives. Should we consider allowing a fund to include offsetting or hedging transactions to reduce its calculated leveraged exposure? Should we exclude certain types of specified derivatives that generally are not expected to help create leverage? If so, does the current definition of "hedging" adequately describe the types of transactions that can reasonably be seen as reducing a fund's net exposure to leverage?

Response:

Subject to our comments with respect to existing commodity pools and below, we generally support the total exposure limit for alternative funds through borrowing, short selling or the use of specified derivatives to no more than 300% of the fund's NAV. We believe that the majority of alternative investment strategies suitable to be offered to retail investors would be able to operate within these constraints.

We are further of the view that there are generally recognized industry standards in Canada, the U.S. and other jurisdictions to determine the notional amount of exposure under a specified derivative that are used by investment fund managers for risk management, reporting and other purposes. We believe that the approach adopted under the Proposed Amendments should allow alternative funds to use these industry standard calculation methods for the purposes of calculating the fund's exposure under the Proposed Amendments. This preferred approach will permit alternative funds to apply the same methodology consistently when calculating their aggregate gross exposure as well as calculating their NAV.

We acknowledge the CSA position that hedging transactions do not necessarily fully offset the risk of any particular position and disregarding the notional value of all hedging transactions from the calculation of aggregate gross exposure may misstate a fund's true leverage position. At this time, we would not propose a change to the definition of "hedging" under NI 81-102. However, we do recommend that the CSA allow alternative funds to subtract or disregard certain offsetting or hedging transactions in specified derivatives that are generally not expected to create leverage.

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. It would also apply to situations in which a fund seeks to reduce or eliminate its economic exposure under a specified derivatives transaction without terminating the transaction.

3. <u>Borrowing</u>

Q8: Should alternative funds and non-redeemable investment funds be permitted to borrow from entities other than those that meet the definition of a custodian for investment fund assets in Canada? Will this requirement unduly limit the access to borrowing for investment funds? If so, please explain why.

Response:

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

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

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

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

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

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

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

4. Interrelated Investment Restrictions

Q12: We seek feedback on the other Interrelated Investment Restrictions and particularly their impact on non-redeemable investment funds. Are there any identifiable categories of non-redeemable investment funds that may be particularly impacted by any of the Interrelated Investment Restrictions? If so, please explain.

With respect to Section 2.6(2) of the Proposed Amendments, it is our view that borrowing cash should not contain many restrictions as there is no counterparty risk to borrowing, in contrast to lending. As the banking industry evolves, there are various competitors to traditional banks that are offering competitive rates to borrowers that non-redeemable investment funds should be able to have access to. Non-redeemable investment funds can be less liquid than an alternative fund and, therefore, access to cash is very important. Canadian scheduled banks or trust companies that are required to have a particular amount of equity may be slow to respond at times and thereby may limit availability of borrowing. To the extent the options are limited to such institutions, the financing they choose to offer, including the terms under which such financing is offered, would be the only options available. As a result, smaller non-redeemable funds may not have the chance to obtain financing or to obtain financing on favourable terms.

In addition, non-redeemable investment funds may have investment strategies in foreign markets and, many times, invest in novel asset classes. Canadian scheduled banks and related entities may not be the best-positioned in such circumstances to provide financing on reasonable terms as they may not have sufficient knowledge of what the fund is investing in. There is no overarching benefit, including investor protection, to restricting access to cash for non-redeemable investment funds.

5. Transition

As a general principle, we submit that existing funds that have been formed and marketed to investors under existing rules (81-102 and 81-104) should be grandfathered and not required to transition to the new rules. Investors invested in these funds on the basis of investment strategies which were fully compliant with applicable rules. We submit that it is not appropriate to require these funds to change their strategies to comply with new rules. Not only would such changes to investment strategies thwart investor expectations, there may be costs involved which with adversely affect the fund and its investors. For example, it may be necessary to hold security holder meetings to approve changes adding cost and uncertainty in the event the changes are not approved (would the fund then have to be wound up?). Furthermore, there may be costs, including tax costs, associated with transactions to bring a fund's portfolio into compliance with new restrictions.

Q16: 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.

6. Other Comments

In addition to our responses to the specific questions posed by the CSA, we also have the following comments on other aspects of the Proposed Amendments:

(a) <u>Historical Performance Record (Part 15 of NI 81-102)</u>

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

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

The Proposed Amendments represent one of most significant developments in the Canadian investment industry in some time and given the unique nature of these changes we recommend that the CSA provide a limited exemption from the prohibition contained in Section 15.6(1) (a) of NI 81-102 to permit alternative funds that convert from a pooled fund to include their historical performance data in their sales communication with the appropriate qualifications.

(b) Counterparty Exposure

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

We welcome opportunities to comment on the Proposed Amendments. We are grateful for your consideration and review and are happy to discuss any of our comments in more detail at your convenience. Please feel free to contact the undersigned, Jason Chertin (Jason.chertin@mcmillan.ca 416-865-7854), Shahen Mirakian (shahen.mirakian@mcmillan.ca 416.865-7238) or Leila Rafi (Leila.rafi@mcmillan.ca 416-945-8017).

Yours truly,

[redacted]

Margaret McNee

Cc: Jason Chertin, McMillan LLP

Shahen Mirakian, McMillan LLP

Leila Rafi, McMillan LLP