PICTON MAHONEY Asset Management

December 22, 2016

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Dear Sirs/Mesdames:

Re: CSA Notice and Request for Comment – Modernization of Investment Fund Product Regulation – Alternative Funds ("Proposed Amendment"), published on September 22, 2016

Picton Mahoney Asset Management ("Picton Mahoney" or "we") is a portfolio manager, investment fund manager and exempt market dealer in various jurisdictions in Canada and a commodity trading manager in Ontario. We are pleased to have the opportunity to comment on the Proposed Amendment.

As of November 30, 2016, Picton Mahoney manages approximately $6.4 billion for institutional and retail investors across equity and fixed income asset classes, using long-only and alternative investment strategies. We focus on volatility management for our investors, by employing portfolio construction techniques to target specific market exposure in each of our investment strategies. We believe that carefully managing the impact of market volatility for the investment portfolios should enable our investors to stay invested over the long term, benefit from the effect of compounding returns, and reach their investment goals more comfortably.

We applaud the efforts of the Canadian Securities Administrators ("CSA") in modernizing investment fund product regulation. The Proposed Amendment will provide retail investors with more investment choices that are currently only available to qualified investors in prospectus-exempt fund structures. It will permit publicly offered mutual funds greater flexibility to use alternative investment strategies that are most suitable to the fund based on the prevailing market conditions. In addition, many alternative strategies are uncorrelated with the long-only strategies employed by existing publicly offered mutual funds; therefore the proposed changes should result in greater diversification benefits for investors.

Nevertheless, there are some elements of the Proposed Amendment that could be enhanced to meet the CSA's objective of modernizing the regulations. For your consideration, we have set out our comments regarding certain aspects of the Proposed Amendment.

Comments on Cash Borrowing

(a) Flexible Borrowing Limits Based on Risk

While we support the CSA's policy objective of protecting investors, it is important to understand that the degree of risk in cash borrowing (to purchase long positions) varies depending on the investment risk of the asset class and other features of the securities. For example, fixed income securities would likely experience lower investment risk than securities in other asset classes. Therefore, a fund that primarily invests in these securities should be permitted to borrow cash in excess of the proposed limit of 50% of net asset value, without necessarily creating undue risk to the fund's investors.

(b) Exception for Cross Currency Borrowing

Some alternative strategies may aim to construct a portfolio consisting of global securities, while maintaining a currency-neutral position in foreign currencies that are not in the fund's accounting currency. In this case, the fund may borrow cash in foreign currency from a prime broker/custodian to purchase foreign securities - thereby achieving a currency-neutral effect on the portfolio - while maintaining net positive cash when positive and negative cash balances in all currencies are converted into the fund's accounting currency. As long as the fund maintains an overall positive cash balance, the fund's borrowing in specific foreign currencies should not be subjected to any cash borrowing limit.

(c) Requirement for Canadian Custodian Lender

The requirement for an alternative fund to borrow from a Canadian custodian who meets the requirements under section 6.2 of National Instrument 81-102 could limit the type of investment strategy and impose a higher operating cost to the fund. Canadian custodians may not have the breadth and depth in global market coverage to serve a fund in certain foreign markets. The Canadian custodians may also face higher funding costs in the lending of foreign currencies, which are passed onto the fund. The Canadian custodians' higher operating costs in foreign markets will reduce the fund's returns and may create operational risks to the detriment of the fund's investors. For these reasons, foreign entities that meet the requirements to act as custodians or sub-custodians for assets held outside of Canada under section 6.3 of National Instrument 81-102 should also be permitted to act as lenders.

Furthermore, the requirement to borrow from and hold portfolio assets at a single custodian may lead to concentration of counterparty risk. Alternative funds should have the ability to use one or more custodians or prime brokers for the purpose of borrowing cash and holding custody of portfolio assets. This will also reduce the operating costs for the fund as the portfolio manager can seek to select the custodian/prime broker that is most cost effective for a given transaction, investment strategy, or market.

(d) Overall Comments on Combined 50% Limit

Finally, we submit that the combined maximum limit for cash borrowing and short selling at 50% of the fund's net asset value is unduly low and would not facilitate a number of common alternative strategies. We will discuss some of these alternative strategies in greater detail in the following sections.

Comments on Short Selling

(a) Short Selling Limit

The use of short selling is a common investment technique employed by funds that engage in alternative strategies. Short selling enables the fund to reduce its risk exposure in a targeted asset class, index, sector, or security, facilitates the market's price discovery process, and provides the fund with the opportunity to profit on the relative value of two securities (such as pair trading). While short selling is an important component in many alternative strategies, we believe that the Canadian mutual fund industry has little experience in managing short selling strategies. Therefore, we support the CSA in adopting a prudent approach to initially set a standalone limit of 50% on short selling and monitor how alternative funds launched under the Proposed Amendments perform in different market environments. Once a full market cycle has been observed (for example, over a five-year period after the Proposed Amendments become effective), the CSA should review these alternative funds and adjust the short selling limit accordingly. This approach will serve to protect investors, while enable those fund managers who currently lack short selling experience to develop their capabilities to use this strategy effectively.

(b) Short Selling Issuer Limit and No Limit for Government Securities

Relative value strategies seek to exploit the pricing inefficiencies between securities while mitigating the risks relating to the securities' maturity, currency, and interest rate movements. For example, a fund may purchase a UK corporate bond and short sell an equivalent amount of UK treasury bonds of the approximate maturity, which allows the fund to capture the change in price between the corporate bond and the treasury bond while eliminating the duration risk of the corporate bond. The proposed rule would restrict alternative funds from pursuing these strategies, due to the short sale limit of 10% of the net asset value in the securities of a single issuer, including government securities. Similarly, in a capital structure arbitrage strategy, a fund may purchase the bond of an issuer and short sell the equity of the same issuer, with the goal of earning the interest income from the bond while mitigating the risk of a decline in the market value of the issuer's securities. The proposed rule would restrict alternative funds from adopting such strategies, due to the mismatch between the long position's concentration limit (20% of net asset value) and the short sale limit (10% of the net asset value). We propose that the short selling limit be raised to 20% of net asset value for securities of the same issuer, and no limit be imposed on the short sales of government securities which are issued by the G10 countries (Belgium, Canada, France, Germany, Italy, Japan, Netherlands, Sweden, Switzerland, United Kingdom, and the United States of America).

(c) Combined Limit on Short Selling and Cash Borrowing

The combined limit of 50% of net asset value in short selling and cash borrowing, in conjunction with the proposed total leverage limit (see comments below), may lead to an unintended consequence: alternative funds could seek to replicate short selling and cash borrowing using derivative instruments to create synthetic short and long exposures, respectively. While the prudent use of derivatives is a widely-accepted alternative strategy, the fund may become exposed to higher costs in the derivatives market and other risks through the use of derivatives, including but not limited to counterparty credit risk for over-the-counter derivative transactions. To remove this unintended consequence, the CSA should not impose an aggregate limit on short selling and cash borrowing that is different than the total leverage limit.

In addition, the combined limit may prohibit certain alternative strategies. For example, in a 130/30 fund, the fund seeks to invest 130% of its net asset value in long positions, while short selling 30% of its net asset value in short positions. This results in a fund that has approximately 100% net exposure (long positions of 130% subtracted by short positions of 30%), with the short positions offering some protection against market decline, and preventing the fund from experiencing any cash drag that might reduce the fund's return potential (due to the short sale proceeds being used to purchase long positions). However, in this case, the 130/30 fund would exceed the combined 50% limit for cash borrowing and short selling. Therefore, we propose that the CSA remove the combined limit on short selling and cash borrowing in order to facilitate this and similar alternative strategies.

Comments on Leverage

(a) Flexible Leverage Limits Based on Risk

While it is beneficial for investors to understand an alternative fund's use of leverage, it is equally important to recognize that not all forms of leverage are the same. Leverage, as determined based on “aggregate gross exposure” as contemplated in the Proposed Amendment, must be considered in the context of the fund’s asset class and security type. As an example, a 3-times levered, emerging markets equity fund would have a very different investment risk and return profile than that of a 3-times levered, investment grade fixed income fund.

(b) Exclusion of Hedging and Offsetting Transactions from Leverage Limit

Another concern with respect to the leverage limit is the determination of the aggregate notional amount. The inability to exclude offsetting or hedging derivative positions in the aggregate notional amount calculation could unfairly penalize a fund in pursuing certain common investment strategies. For example, a global fund that aims to hedge 100% of its foreign currency exposure may enter into currency forward contracts (the Original Contract) with a counterparty. The currency forward contracts are typically “rolled forward” as they approach (but have not reached) the maturity date, by entering into an opposite currency forward contract (the Opposite Contract) with the same counterparty for the same maturity date, and simultaneously entering into a new currency forward contract for a new maturity date (the New Contract). Immediately after the contract roll, the fund remains 100% hedged in its foreign currency exposure; however, it must now report 3 times the notional value of the foreign currency exposure from derivative positions, since the Original and Opposite Contracts remain in the portfolio that cannot be offset against each other until maturity, in addition to the New Contract that is concurrently outstanding.

Similarly, a typical hedging strategy employed by alternative funds involves the use of put-spreads and call-spreads: that is, the fund purchases a long put (call) at a given strike price and simultaneously writes a put (call) on the same underlying security at a different strike price for the same number of contracts. During the life of the option contracts, if the written put (call) is exercised by the counterparty, the fund can exercise the long put (call) to sell (buy) the underlying security to meet the delivery obligations of the written option. When properly constructed, the put-spread/call-spread strategy results in a defined maximum gain and loss profile throughout the life of the option contracts, which mitigates the risk to the fund when compared to a naked call or naked put strategy. Many other option strategies (butterfly, iron condor, long straddle, long strangle) also exhibit similar characteristics with a maximum loss profile. Nonetheless, the inability to remove hedging positions from the aggregate notional amount determination could deter alternative funds from pursuing these investment strategies. As such, we propose that all derivative transactions that are offsetting or hedging should be excluded from the aggregate gross notional amount calculation.

(c) Look-Through Provisions

With regards to a fund’s investment in any underlying funds that also employ leverage, the look-through requirement to include the proportionate amount of leverage utilized by the underlying funds in a fund’s leverage calculation may impose operational challenges. Most publicly offered mutual funds do not offer daily reporting of the portfolio holdings/characteristics. The requirement to incorporate the leverage usage of the underlying funds will inadvertently drive investment funds to only invest in underlying funds from the same or affiliated fund manager. Furthermore, a fund’s exposure to its underlying funds is limited to the market value of the investments (which generally approximates or is equal to the net asset value of the underlying funds); the fund is not subject to any additional exposure from the underlying fund's use of derivatives, short selling and borrowing. We recommend that the CSA amend the definition of aggregate notional amount calculation to remove the look-through requirement.

Comments on Fund Risk Classification

We support the use of a risk classification methodology that is consistent across all types of publicly offered mutual funds and exchange-traded funds, including alternative funds. This will improve an investor's ability to understand a fund's investment risk and make a reasonable comparison across similar funds. However, we caution the CSA not to impose a higher risk rating on alternative funds solely as a result of the fund's use of alternative strategies. When properly employed and monitored by the portfolio manager, certain alternative strategies (such as short selling and derivatives) may reduce the overall volatility and risk of the alternative fund. Any requirement to automatically and indiscriminately impose a higher risk rating for alternative strategies may lead to an incorrect assessment of the fund's investment risk, which will in turn impact the dealer-advisor's suitability assessment for the investor as well as the investor's own perception of the fund's riskiness and return potential.

Furthermore, the CSA had recently published the *Mutual Fund Risk Classification Methodology for Use in Fund Facts and ETF Facts* (Risk Classification Methodology) on December 8, 2016. In light of the alternative strategies that may not have a comparable permitted index that meets the requirements in the Risk Classification Methodology (a typical example is short selling, for which no known permitted index exists that tracks this strategy), additional guidance from the CSA would be appropriate in order for alternative funds to meet the disclosure requirements.

Comment on Proficiency

We agree with the CSA's view that the proficiency requirement for representatives dealing in alternative funds is best addressed through the dealer self-regulatory organizations (SRO). As the CSA and the SROs evaluate the dealer proficiency requirement under a separate initiative, we would like to remind the CSA and SROs of the past experience with the commodity pool market under National Instrument 81-104 *Commodity Pools*. The proficiency and supervisory requirements in NI81-104 are frequently cited as the main reasons for why the dealer representatives were unable to offer commodity pool products to investors, despite the products being suitable for them.

Conclusion

In summary, Picton Mahoney supports the CSA's initiative in modernizing investment fund product regulation. The Proposed Amendment, if modified with our suggested changes, would increase the number of investment options to retail investors – a market segment that has not benefitted from the unique features of alternative strategies in the past. In today's volatile markets, retail investors and their investment advisors will need all available tools at their disposal in order to reach their investment goals with greater certainty.

PICTON MAHONEY Asset Management

Picton Mahoney appreciates the opportunity to provide our comments on this important regulatory initiative. We would be pleased to discuss any of the matters raised in this letter in greater detail.

Sincerely,

David Picton
President, Chief Executive Officer
Picton Mahoney Asset Management

Andrew Ma
Chief Compliance Officer
Picton Mahoney Asset Management