Global Asset
Management

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Via email

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

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December 22, 2016

Dear Sirs and Mesdames,

Re: CSA Notice and Request for Comment – Modernization of Investment Fund Product Regulation – Alternative Funds

We are writing in response to the Canadian Securities Administrators' ("**CSA**") notice and request for comment on the Modernization of Investment Fund Product Regulation – Alternative Funds, published on September 22, 2016 (the "**Request for Comment**").

Introduction

RBC Global Asset Management Inc. ("**RBC GAM**") is a wholly-owned subsidiary of Royal Bank of Canada and provides a broad range of investment management services and solutions to investors across Canada, including through a variety of mutual funds. As at September 30, 2016, RBC Global Asset Management had over $390 billion in investment fund assets under management.

We reiterate the support we expressed in our August 2013 comment letter (the "**RBC GAM 2013 Comment Letter**") regarding the CSA's initial proposal to enable certain types of alternative funds to offer their securities to the retail investors. We believe that retail investors will benefit from having access to a wider array of investment choices, including investment funds that focus on alternative asset classes or that use alternative strategies not currently permitted by NI 81-102 – *Investment Funds* ("**NI 81-102**").

Alternative investment solutions that employ a wider range of investment tools to generate returns and/or reduce volatility have been increasingly used by institutions globally to improve their investment returns and manage risk. The use of such strategies can effectively reduce overall levels of portfolio volatility while allowing exposure to solutions which may improve expected returns with reduced correlations. Retail clients can benefit from having access to a broader range of tools, which can effectively improve investment efficiency over time when employed in a portfolio setting.

RBC GAM, as a manager of both conventional mutual funds and alternative investment funds, welcomes the opportunity to comment on what constraints would be appropriate for alternative funds that could be offered under a revised NI 81-102 to retail investors. Set out below are our comments on the specific questions relating to the Request for Comment on which the CSA has requested feedback, in the same order in which they are listed in Annex A to the Request for Comment.

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?*

Our understanding is that the CSA is *not* proposing that "alternative funds" or "conventional funds" or "non-redeemable investment funds" would need to identify themselves as such in the funds' names, and we support this approach. We also appreciate the need to adopt definitional terms for purposes of differentiating amongst the three categories of funds for purposes of re-drafting NI 81-102 and the related instruments and forms. So long as such definitional terms are used for purposes of regulatory drafting (i.e., there will be no requirement to label a fund as an "alternative fund" or a "conventional fund" or a "non-redeemable investment fund" in the fund's name or otherwise), then we are fine with the use of the term "alternative fund" to define the new category of funds.

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.*

As we had indicated in the RBC GAM 2013 Comment Letter, we urge the CSA to consider including further exemptions from the restrictions in NI 81-102 to permit alternative funds to invest more fully in mortgages and loan syndications/participations. We recommend that alternative funds be exempted from paragraphs 2.3(b) and (c) of NI 81-102 to permit alternative funds to invest up to 100% of their net asset value in non-guaranteed mortgages and an unlimited amount in guaranteed mortgages. We also recommend that alternative funds be exempted 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 a private placement basis. As an example, RBC GAM has long operated a privately-offered mortgage fund that holds non-guaranteed mortgages. This solution has never experienced a default and has provided consistently higher spreads for the benefit of investors relative to those provided by a conventional guaranteed mortgage investment over time. RBC GAM believes that it would be in retail investors' interests to have access to these types of investment solutions, where suitable.

In addition, we note that the proposed limit on short-selling at 50% of the fund's market value would prohibit certain market neutral strategies where a portfolio of securities are held long against a portfolio of securities held short. These types of strategies permit investors to benefit from the relative performance of the portfolios while minimizing both market exposure and volatility. We ask you to please consider expanding the short-sell limit to allow that market neutral strategies be permitted under the Proposed Amendments.

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.*

We agree with a proposed concentration limit for alternative funds at 20% of NAV. In addition, we propose allowing alternative funds to exceed this limit in the event it compromises an alternative fund manager's ability to track the index and introduces a tracking error. Some alternative funds closely track indices (or benchmarks) that are not subject to low concentration limits. Expanding the concentration limits contained in NI 81-102 for alternative funds would permit managers of such funds to express stronger views regarding portfolio holdings (i.e., to more heavily overweight or underweight fund holdings). Alternative funds are recognized as being, in many cases, more concentrated than conventional mutual funds, and alternative fund managers should be permitted to create somewhat more concentrated portfolios to deliver on

investment strategies so long as they appropriately control for issuer risk and provide appropriate disclosure to investors.

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.*

Yes, there are certain strategies commonly used by alternative funds for which a higher illiquid asset investment threshold would be appropriate, and it would be beneficial for investors who do not have a high liquidity constraint for their portfolio or a portion thereof (for instance, as a result of a longer investment horizon) to have access to such strategies.

Alternative strategies may include positions that are by their nature less liquid, such as high yield bonds, distressed securities or longer life assets such as mortgages that have a less liquid secondary market. Alternative strategies that access these markets provide clients with exposure to outcomes that benefit from the illiquidity premium inherent in less liquid assets as well as situations in which a particular event will unlock value but that may take somewhat longer than typical public market strategies to play out. By allowing for exposure to these types of less liquid assets and strategies, individual investors will have access to the benefits that have thus far been limited to accredited and institutional investor segments.

Examples of strategies that require a higher illiquid asset threshold include distressed investing, merger arbitrage (where a specific takeover event is required to unlock expected value), direct real estate, investments in certain mortgages and loans where a more illiquid secondary market requires more time to efficiently sell positions without disadvantaging investors.

In addition, retail clients may benefit from access to certain fund of fund pooled solutions that diversify risk across numerous uncorrelated strategies in a single vehicle. Typically these types of vehicles will have slightly longer notice periods as the underlying funds or strategies have differing liquidity conditions. For example a number of daily liquid strategies may be included in the "top", or investing, fund's portfolio, along with a less liquid mortgage or distressed strategy within the top fund's overall allocation, thus increasing the required notice period and reducing liquidity to the most illiquid strategy included in the top fund's portfolio. Without the ability to provide monthly or quarterly liquidity, these types of solutions may remain out of reach for retail clients, where the risk, volatility and correlative profile may be beneficial in their portfolio construction and be of value in helping them achieve their investment objectives.

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.*

Yes, generally speaking, the less frequently redemptions are permitted, the more illiquid securities a fund may prudently invest in. There should be a direct link between the two.

Relaxing the redemption constraint and allowing for less frequent redemptions would allow investors to access strategies that may require somewhat longer time periods to play out and as a result provide higher levels of expected return. Allowing retail investors to access this "liquidity premium" would

provide significant benefits to this class of investors who have to this point been excluded from enjoying this flexibility. This is especially true for those who don't require access to the invested funds for long periods into the future.

Alternative asset managers should be permitted to pursue strategies that involve investing in a greater proportion of illiquid assets so long as the manager has appropriate policies and procedures in place to manage liquidity risk, and so long as investors are provided with fulsome disclosure relating to liquidity risk and the manager's related policies and procedures. The CSA should also consider further expanding NI 81-102 to provide for additional liquidity risk-management tools, such as: allowing for the suspension of redemptions at the manager's discretion and providing managers with the ability to require longer notice periods for fund withdrawals.

One specific example of how an alternative fund manager may mitigate liquidity risk would be to allow for monthly or even quarterly redemption notice periods and to maintain related limits on the percentage of a portfolio that requires more time than the notice period to liquidate. For instance, appropriately risk-managed funds would maintain records and run regular analyses on the 1-day, 1-week, 1-month (and so on) liquidity metrics of their portfolios. This could be a feature of funds that hold assets that require more than their stated monthly or quarterly liquidity terms to provide adequate redemption liquidity.

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 nonredeemable investment funds. In particular, we seek feedback on whether there are any specific types or categories of nonredeemable 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).*

No comment.

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 nonredeemable investment fund does not allow securities to be redeemed at NAV.*

No comment.

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.*

Alternative funds very frequently rely heavily on the services of prime brokers. In addition to other services, prime brokers will often provide credit to alternative funds, and it is therefore essential that NI

81-102 be flexible enough to permit alternative funds to borrow from prime brokers and, more broadly, to continue to use prime brokerage services, both from Canadian-based prime brokers and from foreign prime brokers.

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.*

Yes. Funds that hedge various exposures will be affected. For example, some fixed income/credit based funds may employ strategies to hedge different sources of risk inherent in investing in the bond market, including interest rate risk, credit risk or yield curve risk. Should these funds enter into multiple hedging instruments, such as interest rate swaps or futures, they would not be able to fully execute their investment strategies under the proposed (strict) leverage limit. Other examples include absolute return funds.

The nature of many alternative strategies leads them to employ a variety of tools to establish positions, exposures and mitigate risks within a portfolio. To this end, in many cases a limit on gross exposures, in particular without regard for the nature of the leverage and the exposures that it creates, may not have the intended effect of protecting investors.

We believe that it is critical to consider not only gross exposures, but also the net exposures within a portfolio. Where gross exposures are offset to create limited exposure to market beta, or are used to hedge out unwanted interest rate or foreign currency exposures, as examples, we believe that they should be excluded from the gross notional exposure calculation as per the "commitment method" discussed below.

One simple example could be a U.S. relative value credit fund with $100 in NAV, which buys $150 long exposure to corporate bonds (using $50 of borrowing) that the manager believes will outperform and that goes short (via CDS) $150 corporate bonds or indices in credits that the manager believes will underperform or as a hedge to the overall broad credit exposure within the portfolio. In this case there would be 300% notional exposure with very little actual market or beta risk. In addition, in order to protect investors from any interest rate exposure, any residual interest rate risk would be covered by a short interest rate overlay (i.e. interest rate swaps, short treasury futures). As a result, let us assume for illustrative purposes that the fund would have an additional $100 of notional short interest rate positions bringing gross leverage to 400% with little to no actual broad market exposure. Finally, to ensure Canadian investors are protected from U.S. currency volatility, the fund would hedge out any residual U.S. dollar exposure using forward contracts, hedging to the base currency of the fund, thus creating additional notional leverage. However, despite the fund having in excess of 400% notional leverage, the result of all of these offsetting positions is a clear and net reduction in risk since market, interest rate and currency risk (and thus volatility) have been substantially mitigated.

Similarly, market neutral equity funds are another category of strategies that would be limited by both the leverage and the cash shorting limits, but that provide investors with significant benefits from a risk and volatility perspective. In these strategies, long positions in a portfolio of stocks expected to outperform is offset by short positions in a portfolio of stocks expected to underperform. Often the portfolio will be run specifically to achieve zero correlation to the underlying market beta, limited sector

net exposures and significantly lower levels of risk (volatility) than that of the underlying equity markets. In these funds the limits on shorting to 50% would effectively eliminate the manager's ability to build a fully hedged portfolio through the use of cash shorts as these funds typically run portfolios that are 100%-150% long a portfolio of stocks they believe will outperform a 100%-150% short portfolio of highly correlated stocks. This portfolio would have at least 300% leverage, but would be unable to achieve this positioning due to the shorting limitations proposed and potentially the notional leverage limits.

By contrast, a simple 300% notional exposure limit could result in an equity portfolio that is $150 long Canadian stocks (using $50 of borrowing), plus derivative positions (i.e., Total Return Swaps or Call Options) providing an additional $150 notional long exposure to equities. This would result in a portfolio entirely exposed to the equity markets, with three turns of leverage.

With these examples in mind, we would suggest that much like under UCITs rules in Europe, either a Value at Risk (VaR) methodology be applied to ensure that leverage employed results in expected (and ex-post) volatility remains within a certain range or that the "committed method" with offsetting leverage rules apply that allow for notional exposure to offset if corresponding long positions and short positions have a minimum expected and historical correlation.

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?*

Yes, that would be appropriate and should consider both derivative positions and cash shorting where hedging of risk is the primary result. We disagree with including derivative and cash shorting transactions' notional amount in the definition of leverage if those transactions are used to reduce the overall risk/volatility of the portfolio. We believe that the intent of limiting funds' leverage is to limit the risk to which investors may be exposed when market events work against the investment strategy. Including those transactions that are used to hedge portfolio market exposure is not appropriate and is contrary to what we believe is the intent of the Proposed Amendments. Offsetting or hedging transactions should 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 (see Appendix A, attached). According to this Article, for the calculation of the exposure of an alternative investment fund in accordance with the commitment method, a manager should:

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 of the journal and

b) apply netting and hedging arrangements.

For the purposes of calculating the exposure of an alternative investment fund according to the commitment method:

a) Netting arrangements are to 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 arrangements are to 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 should be permitted 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.

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. There are a number of derivative strategies that are used to offset a portfolio's risk and do not add to its overall market exposure, though would contribute to the calculation of notional leverage. In particular, as noted above, derivatives such as IRS and CDS, as well as short futures - where duration matching can require significant notional leverage to create offsetting positions where reduction of longer duration interest rate exposures are desired – should be carefully considered. Therefore, one option to improve the leverage measurement methodology is to simply exclude the hedging transactions from the leverage calculation. This way, investors would know exactly how much 'additional' market exposure they are getting from a fund. 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 regular, conventional mutual fund that follows the same strategy, everything else being equal. Another way to measure the total risk of a fund resulting from the use of 'effective' leverage is to apply a measure such as VaR. Comparing VaR between two funds enables an investor to directly contrast the funds' market risk levels. We support the leverage calculation known as "the committed method" as described in our answer to the previous question.

Interrelated Investment Restrictions

12. *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.*

No comment.

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.*

No comment.

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 management tool is not, in our view, sufficient. While standard deviation is an informative measure, it can mask risks that arise as a result of the complexity of an investment product. As an example, a short-term fixed income mutual fund could have very low historical volatility over the measurement period, 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 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. As a result, additional metrics such as VaR should also be considered.

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.*

No comment.

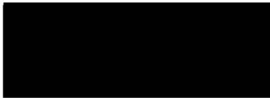
Transition

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.*

The proposed period seems sufficient to allow existing funds to transition to the updated regulatory regime.

We appreciate the opportunity to provide comments on this important initiative and welcome the opportunity to discuss the foregoing with you in further detail. If you have any questions or require further information, please do not hesitate to contact the undersigned.

Sincerely,



Daniel E. Chornous, CFA
Chief Investment Officer

cc. Larry Neilsen, Chief Compliance Officer, RBC Global Asset Management Inc.
Lorraine Lynds, Senior Counsel, RBC Global Asset Management Inc.

Appendix A

Article 8 of the Official Journal of the European Union, Section 2: Calculation of Leverage: "the committed method"

[See attached]