CSA/ACVM Canadian Securities Administrators Autorités canadiennes en valeurs mobilières

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

September 22, 2016

Introduction

The Canadian Securities Administrators (the CSA or we) are publishing for a **90-day** comment period

- the proposed repeal of National Instrument 81-104 *Commodity Pools* (NI 81-104)
- proposed amendments to:
  - National Instrument 81-102 *Investment Funds* (NI 81-102),
  - National Instrument 81-101 *Mutual Fund Prospectus Disclosure* (NI 81-101), including Form 81-101F3 *Contents of Fund Facts Document* (the Fund Facts),
- proposed consequential amendments to:
  - Form 81-101F1 *Contents of Simplified Prospectus* and Form 81-101F2 *Contents of Annual Information Form*,
  - National Instrument 81-107 *Independent Review Committee for Investment Funds* (NI 81-107),
  - National Instrument 41-101 *General Prospectus Requirements* (NI 41-101), including Form 41-101F2 *Information Required in an Investment Fund Prospectus* (Form 41-101F2), and
  - National Instrument 81-106 *Investment Fund Continuous Disclosure* (NI 81-106).

(collectively, the Proposed Amendments).

In addition, we are publishing proposed changes to Companion Policy 81-102CP *Investment Funds* and proposing to withdraw Companion Policy 81-104CP *Commodity Pools*.

The Proposed Amendments represent the final phase of the CSA's ongoing policy work to modernize investment fund product regulation (the Modernization Project) and is primarily aimed at the development of a more comprehensive regulatory framework for publicly offered mutual funds that wish to invest in asset classes or use investment strategies not otherwise permitted under NI 81-102.

Background

The Proposed Amendments are part of the CSA's implementation of the Modernization Project. The mandate of the Modernization Project has been to review the parameters of product regulation that apply to publicly offered investment funds (both mutual funds and non-redeemable investment funds) and to consider whether our current regulatory approach sufficiently addresses product and market developments in the Canadian investment fund industry, and whether it continues to adequately protect investors. The Proposed Amendments, if adopted, are expected to have a meaningful impact on publicly offered mutual funds that utilize alternative strategies or invest in alternative asset classes (alternative funds) and would also affect other types of mutual funds (namely conventional mutual funds and ETFs) as well as non-redeemable investment funds.

The Modernization Project has been carried out in phases. With Phase 1 and the first stage of Phase 2 now complete, the Proposed Amendments represent the second and final stage of Phase 2 of the Modernization Project.

Phase 1

In Phase 1, the CSA focused primarily on publicly offered mutual funds, codifying exemptive relief that had been frequently granted in recognition of market and product developments. As well, we made amendments to keep pace with developing global standards in mutual fund product regulation, notably introducing asset maturity restrictions and liquidity requirements for money market funds. The Phase 1 amendments came into force on April 30, 2012, except for the provisions relating to money market funds, which came into force on October 30, 2012.

Phase 2 – First Stage

In the first stage of Phase 2, the CSA introduced core investment restrictions and fundamental operational requirements for non-redeemable investment funds. We also enhanced disclosure requirements regarding securities lending activities by investment funds to better highlight the costs, benefits and risks, and keep pace with developing global standards in the regulation of these activities. The Phase 2 amendments substantially came into force on September 22, 2014, except for certain transitional provisions that came into force on March 21, 2016.

Phase 2 – Second Stage – the Alternative Funds Proposal

The CSA first published an outline of a proposed a regulatory framework for alternative funds (the Alternative Funds Proposal), on March 27, 2013 as part of Phase 2 of the Modernization Project. In describing the Alternative Funds Proposal, the CSA did not publish proposed rule amendments. Instead, a series of questions were asked that focused on the broad parameters for such a regulatory framework (the Framework Consultation Questions).

The Alternative Funds Proposal dealt with issues such as naming conventions, proficiency standards for dealing representatives, and investment restrictions. We also proposed a number of areas where alternative investment funds could be permitted to use investment strategies or

invest in asset classes not specifically permitted under NI 81-102 for mutual funds and non-redeemable investment funds, subject to certain upper limits.

On June 25, 2013, we published CSA Staff Notice 11-324 *Extension of Comment Period* (CSA Staff Notice 11-324), which advised that the CSA had decided to consider the Alternative Funds Proposal at a later date, in conjunction with certain investment restrictions for non-redeemable investment funds that we considered to be interrelated with the Alternative Funds Proposal (the Interrelated Investment Restrictions) as part of the second stage of Phase 2.

On February 12, 2015, we published CSA Staff Notice 81-326 *Update on an Alternative Funds Framework for Investment Funds*, where we briefly described some of the feedback we received in connection with the Framework Consultation Questions.

Summary of Proposed Amendments

Since NI 81-104 first came into force, the range of investment fund products and strategies in the marketplace has expanded significantly, both in Canada and in other jurisdictions. The Proposed Amendments reflect the CSA's efforts to modernize the existing commodity pools regime by making the regulatory framework in Canada more effective and relevant to help facilitate more alternative and innovative strategies while at the same time maintaining restrictions that we believe to be appropriate for products that can be sold to retail investors.

The Proposed Amendments, while focused on alternative funds, also include provisions that will impact other types of mutual funds, as well as non-redeemable investment funds through the Interrelated Investment Restrictions. The Proposed Amendments seek to move most of the regulatory framework currently applicable to commodity pools under NI 81-104 into NI 81-102 and rename these funds as "alternative funds". They also seek to codify existing exemptive relief frequently granted to mutual funds, and to include additional changes arising from the feedback received on the proposals set out in the Framework Consultation Questions.

The key elements of the Proposed Amendments are outlined below. A consolidated list of the specific issues in the Proposed Amendments to NI 81-102 on which we seek comment is set out in Annex A to this Notice.

(i) Repeal of NI 81-104

As noted above, the CSA are proposing that the operational framework and investment restrictions applicable to alternative funds be contained within NI 81-102 rather than spread between separate instruments, as is currently the case for commodity pools with NI 81-102 and NI 81-104. This change would necessitate the repeal of NI 81-104, and the subsequent adoption of any applicable provisions into NI 81-102.

This proposal is consistent with the work done in the first stage of Phase 2 of the Modernization Project to integrate non-redeemable investment funds into the NI 81-102 regulatory framework, and fulfills the goal of transforming NI 81-102 into the foundational operational rule for all investment funds.

(ii) Definition of "Alternative Fund"

The CSA are proposing to replace the term "commodity pool" that exists in NI 81-104 with "alternative fund", a new term in NI 81-102 that we think will better describe the types of investment objectives and strategies that characterize these types of funds.

The current definition of "commodity pool" in NI 81-104 refers to a mutual fund that has adopted fundamental investment objectives that permit it to use or invest in specified derivatives or physical commodities in a manner not permitted by NI 81-102. The CSA are proposing a similar approach to the term "alternative fund" in NI 81-102, by defining it as a mutual fund that has adopted fundamental investment objectives that permit the mutual fund to invest in asset classes or adopt investment strategies that are otherwise prohibited, but for prescribed exemptions from the investment restrictions in Part 2 of NI 81-102. This also reflects that the Proposed Amendments would result in a more comprehensive range of alternative fund-specific provisions than is currently the case for commodity pools.

(iii) Investment Restrictions

Concentration Restrictions

To allow for greater flexibility to engage in alternative investment strategies, we are proposing to permit alternative funds to have a higher concentration restriction than the current limit applicable to conventional mutual funds and to commodity pools under NI 81-102. Specifically we are proposing to increase the limit from 10% of net asset value (NAV) to 20% of NAV for alternative funds. As part of the Interrelated Investment Restrictions, we also propose setting the same concentration limit for non-redeemable investment funds. Currently the concentration restriction does not apply to non-redeemable investment funds, but many existing non-redeemable investment funds have adopted a concentration restriction that requires them to limit their investment in an issuer to no more than 20% of NAV at the time of purchase.

The proposed higher concentration limit for alternative funds and non-redeemable investment funds ensures consistency in terms of regulatory approach for all investment funds, while also providing flexibility to offer investors access to alternative investment strategies.

Investments in Physical Commodities

For mutual funds that do not qualify as alternative funds, we are proposing to expand the scope of permitted investment in physical commodities. Currently, mutual funds (other than commodity pools which are exempt from these provisions) can invest up to 10% of their NAV in gold (including 'permitted gold certificates'), but are otherwise prohibited from investing directly, or indirectly through the use of specified derivatives, in physical commodities other than gold (the Commodity Restriction). Under the Proposed Amendments, the scope of permitted investments under the Commodity Restriction would be expanded to allow mutual funds to:

- invest directly in silver, palladium and platinum, in addition to gold (including certificates representing these precious metals), and

- obtain indirect exposure to any physical commodity through the use of specified derivatives.

This new range of permitted investment in physical commodities would remain subject to a combined limit of 10% of the mutual fund's NAV at the time of purchase, consistent with the current Commodity Restriction. This proposed change reflects exemptive relief that has been regularly granted to mutual funds and recognizes that physical commodities represent an asset class that can be used effectively within a diversified investment portfolio. We are also proposing to add a "look through" test in which investments in underlying funds would be counted towards the overall limit, primarily to ensure that funds cannot indirectly exceed the proposed investment caps through fund of fund investing.

As part of this change, we also propose to add the new definitions "permitted precious metal" and "permitted precious metal certificate" to NI 81-102, to reflect the inclusion of silver, platinum and palladium within the scope of physical commodities that can be held directly by mutual funds, and to repeal the definition of "permitted gold certificate".

Under NI 81-104, commodity pools are exempt from the provisions in section 2.3 of NI 81-102 governing investment in physical commodities and we are proposing to maintain this exemption for alternative funds under NI 81-102. Non-redeemable investment funds are also exempt from these provisions and we are not proposing to change this.

Currently, there are mutual funds that have received exemptive relief from NI 81-102 to be "precious metals funds" (as currently defined in NI 81-104) because their fundamental investment objectives provide that they invest primarily in one or more precious metals. We are proposing to adopt this definition into NI 81-102. Under the Proposed Amendments, mutual funds that fit this definition would be exempt from the 10% limit on investment in physical commodities in respect of their investment in permitted precious metals. This would not represent a change in how precious metals funds currently operate.

Illiquid Assets

We are proposing to introduce a limit on investing in illiquid assets for non-redeemable investment funds. Currently all mutual funds are not permitted to invest in illiquid assets if, after the purchase, more than 10% of the fund's NAV would be invested in illiquid assets; and all mutual funds are subject to a hard cap of 15% of NAV. However, non-redeemable investment funds are not subject to such a limit under our current rules. The Proposed Amendments introduce an investment limit in illiquid assets of 20% for non-redeemable investment funds, with a hard cap of 25% of NAV.

The proposed limit for investments in illiquid assets by non-redeemable investment funds reflects the fact that unlike mutual funds, non-redeemable investment funds generally do not offer regular redemptions based on NAV. Rather, most non-redeemable investment funds primarily offer liquidity through listing their securities on an exchange. However, a significant number of non-redeemable investment funds do offer some form of redemptions at a price based on the fund's NAV once a year, as well as, in many cases monthly redemptions at a price tied to market price, and therefore we believe a restriction on illiquid assets is important in order for those funds to meet their redemption requirements as applicable. We are seeking comment on the proposed limit on illiquid asset investments for non-redeemable investment funds.

We are not proposing to increase the permitted level of investment in illiquid assets for alternative funds or for other mutual funds. However, we recognize that there may be cases where certain types of alternative funds may, in accordance with their investment objectives wish to hold a larger proportion of their portfolio in illiquid assets, and will often accordingly offer redemptions on a less frequent basis. We seek feedback on whether a higher illiquid asset limit may be appropriate in those cases, and how best to make that work within the existing framework.

In addition, we continue to stay abreast of the various initiatives on liquidity risk management for investment fund products at the international level and how this may impact our work on this stage of the Modernization Project.

Fund-of-Fund Structures

We are proposing to permit mutual funds (other than alternative funds) to invest up to 10% of their net assets in securities of alternative funds and non-redeemable investment funds, provided those underlying funds are subject to NI 81-102. This reflects a recognition that some access to these types of products can be beneficial to a mutual fund's strategies.

We are also proposing to permit mutual funds to invest up to 100% of their NAV in any other mutual fund (other than an alternative fund) that is subject to NI 81-102, rather than just those that file a simplified prospectus (SP) under NI 81-101. This change would codify existing exemptive relief and would have the effect of permitting a mutual fund to also invest up to 100% of its NAV in exchange-traded mutual funds, whereas currently, they are limited to investing only in conventional mutual funds that file an SP. We are also proposing to remove the restriction that a mutual fund must invest in another investment fund that is a reporting issuer in the same "local jurisdiction" as the top fund. This means that a mutual fund will be able to invest in another investment fund so long as it is a reporting issuer in at least one Canadian jurisdiction, and reflects the fact that investment fund regulation is substantially harmonized in the Canadian jurisdictions. We are not proposing changes to any other aspect of the fund-of-fund rules under NI 81-102 for mutual funds.

Currently commodity pools under NI 81-104 are subject to the same fund of fund investing restrictions that apply to "conventional" mutual funds. These restrictions act to prevent a commodity pool, for example, from investing in another commodity pool or in any other type of fund, unless it is a mutual fund that has filed an SP under NI 81-101. We are proposing to permit

alternative funds to invest up to 100% of their NAV in any other mutual fund (which includes other alternative funds) or in non-redeemable investment funds provided the other fund is subject to NI 81-102. The other provisions applicable to fund of fund investing by mutual funds would still apply.

Currently, non-redeemable investment funds can invest up to 100% of their NAV in other investment funds and we are not proposing to change this, or any of the other fund of fund provisions that apply to non-redeemable investment funds.

Borrowing

The CSA are proposing to permit alternative funds to borrow up to 50% of their NAV in order to help facilitate a wider array of investment strategies by alternative funds than may be possible under the current restrictions. We are also proposing that these provisions apply to non-redeemable investment funds.

In addition, we are proposing that borrowing for both alternative funds and non-redeemable investment funds be subject to the following requirements:

- funds may only borrow from entities that would qualify as an investment fund custodian under section 6.2 of NI 81-102, which essentially restricts borrowing to banks and trust companies in Canada (or their dealer affiliates);

- where the lender is an affiliate of the alternative fund's investment fund manager, approval of the fund's independent review committee (IRC) would be required under NI 81-107; and

- any borrowing agreements entered into under this section must be in accordance with normal industry practise and be on standard commercial terms for agreements of this nature.

We are also proposing to amend the IRC approval provisions in section 5.2 of NI 81-107 in order to codify the IRC approval requirement described above, in that Instrument.

Short Selling

The CSA are proposing to permit alternative funds to sell securities short beyond the current limits in NI 81-102 to provide these funds with more flexibility to use long/short strategies. In particular, we are proposing to increase the aggregate market value of all securities that may be sold short by an alternative fund to 50% of the NAV of the fund, which is an increase from the current limit of 20% of NAV for all mutual funds (including commodity pools). We note that a number of commodity pools have already been granted exemptive relief to increase the aggregate market value of securities permitted to be sold short, to 40% of the fund's NAV. We are also proposing to increase the aggregate market value of all securities of any issuer that may be sold short by an alternative fund to 10% of the NAV of the fund, calculated at the time of the

short sale, which is an increase from the 5% limit currently applicable to mutual funds (including commodity pools).

In addition, we are proposing to exempt alternative funds from subsections 2.6.1(2) and (3) of NI 81-102, which require funds to hold cash cover and prohibit the use of short sale proceeds to purchase securities other than securities that qualify as cash cover. This is to help facilitate the use of "long/short" strategies by alternative funds in Canada.

We are also proposing that the same short-selling provisions applicable to alternative funds also apply to non-redeemable investment funds as part of the Interrelated Investment Fund Restrictions.

Combined Limit on Cash Borrowing and Short Selling

We are proposing that the combined use of short-selling and cash borrowing by alternative funds and non-redeemable investment funds be subject to an overall limit of 50% of NAV. That is, under the Proposed Amendments, an investment fund that is either a non-redeemable investment funds or an alternative fund would not permitted to borrow cash or sell securities short if after doing so, the aggregate value of its short-selling and cash borrowing exceeds 50% of the fund's NAV. We view short-selling as another form of borrowing, and therefore believe it should be subject to the same borrowing limit as cash borrowing.

Use of Derivatives

Dodd-Frank Relief

One of the changes we are proposing is to codify exemptive relief frequently granted to mutual funds in response to the enactment of the *Dodd-Frank Wall Street Reform and Consumer Protection Act* (and the rules promulgated thereunder) in the United States and similar legislation in Europe (the Dodd-Frank Relief). Under this legislation, certain types of swaps are required to be cleared through a clearing corporation that is registered with the applicable regulatory agency in the US or in Europe. This legislation is part of an international initiative to more tightly regulate over-the-counter (OTC) derivatives, in response to the 2007-2008 financial crisis.

The Dodd-Frank Relief consists of relief from the counterparty designated rating requirement of subsection 2.7(1) of NI 81-102, the counterparty exposure limits of subsection 2.7(4) of NI 81-102 and the custodian requirements of part 6 of NI 81-102. It is intended to facilitate the entering into of transactions for cleared derivatives under the infrastructure mandated by those legislative reforms.

In order to codify this exemption, we are proposing to create a new defined term "cleared specified derivative", which will refer to any specified derivative that is cleared through this mandated infrastructure.

In turn, we propose to provide an exemption for all investment funds from subsections 2.7(1) and 2.7(4) of NI 81-102 for exposure to "cleared specified derivatives" and to amend section 6.8 of NI 81-102 in order to provide a specific exemption from the general custodian requirement to permit a fund to deposit assets with a dealer as margin in respect of cleared specified derivatives transactions.

Counterparty Requirements

We are proposing to exempt alternative funds from subsection 2.7(1) of NI 81-102. Currently, commodity pools are exempt from paragraph 2.7(1)(a) pursuant to NI 81-104, but are still subject to the requirements in paragraphs (b) and (c). As a result of the proposed change, a fund would no longer be prohibited from entering into certain specified derivatives transactions where either the derivative itself, or the counterparty (or the counterparty's guarantor), does not have a "designated rating" as defined in NI 81-102. This change would permit alternative funds to engage in OTC derivatives transactions with a wider variety of international counterparties. Since the financial crisis of 2007-2008, fewer firms that have been able to attain a "designated rating", which in turn limits the number of available counterparties. Access to a larger variety of counterparties can provide benefits to alternative funds in terms of pricing or products. Non-redeemable investment funds are already exempt from this subsection and we are not proposing to change that exemption.

To counterbalance the proposed exemption from subsection 2.7(1) for alternative funds, we are proposing to eliminate the exemption for commodity pools from the counterparty exposure limits in subsections 2.7(4) and 2.7(5) currently available to commodity pools under NI 81-104, and to non-redeemable investment funds under NI 81-102 (the Counterparty Exposure Exemption). Under the Proposed Amendments, both alternative funds and non-redeemable investment funds would, subject to the general exemption for cleared specified derivatives referred to above, be required to limit their mark-to-market exposure limit with any one counterparty to 10%.

Repealing the Counterparty Exposure Exemption is intended to reduce the credit risk to a single counterparty, particularly in connection with OTC derivatives. Where an alternative fund's exposure to a single counterparty constitutes a significant amount of the fund's NAV, we think that the risks associated with such exposure, particularly the credit risk of the counterparty, may materially alter the nature and risk profile of the fund.

We also note that large counterparty exposures through OTC derivatives may be inconsistent with the restrictions on investments in illiquid assets.

Cover Requirements

We are proposing to maintain for alternative funds, the current exemption from sections 2.8 and 2.11 of NI 81-102 applicable to commodity pools under NI 81-104, to permit an alternative fund to use specified derivatives to create synthetic leveraged exposure. Non-redeemable investment funds would remain exempt from these provisions.

Leverage

Under the Proposed Amendments, alternative funds and non-redeemable investment funds may achieve leverage through a number of ways, including cash borrowing, short selling and specified derivatives transactions. They may also obtain exposure through investing in underlying funds that employ leverage. Although the provisions relating to these investment strategies may specify limits on their use individually, we are proposing to create a single limit on the total leveraged exposure of an alternative fund or non-redeemable investment fund may have through these various strategies. This limit will also be used for disclosure purposes.

We are proposing that the aggregate gross exposure by an alternative fund or a non-redeemable investment fund, through borrowing, short-selling or the use specified derivatives cannot exceed 3 times the fund's NAV.

Specifically, a fund would have to calculate

- the total amount of outstanding cash borrowed,
- the combined market value of securities it sells short, and
- the aggregate notional amount of its specified derivatives positions, including those used for hedging purposes.

This would be divided that by the fund's net assets to determine whether this exposure falls within the prescribed limit. Under the Proposed Amendments, the total leverage limit would have to be met by alternative funds and non-redeemable investment funds on an ongoing daily basis, and not just at the time of entering into a transaction that creates leverage.

We note an absence of uniform standards for measuring leverage. Leverage can be measured in different ways and may require different assumptions. We chose this methodology primarily because it is a relatively simple calculation and relies primarily on objective criteria thereby providing a common comparative standard by which to measure a fund's leveraged exposure. However, we recognize that that there are other methods for measuring leverage in a fund, and keeping abreast of international developments in this regard[1].

We seek feedback on this proposed limit and whether the total leverage limit should be the same for mutual funds and non-redeemable investment funds, considering a mutual fund's need to fund regular redemptions. We also seek feedback on the methodology proposed under the Proposed Amendments for measuring leverage.

[1] The Financial Stability Board has identified leverage within investment funds as an area for further analysis in its work to address structural vulnerabilities from asset management activities. See: Financial Stability Board, Proposed Policy Recommendations to Address Structural Vulnerabilities from Asset Management Activities – Consultation Document (22 June 2016), online: http://www.fsb.org/wp-content/uploads/FSB-Asset-Management-Consultative-Document.pdf

(iii) New Alternative Funds

Seed Capital and Organizational Costs

For alternative funds, the CSA are proposing changes to the seed capital and other start-up requirements currently applicable to commodity pools under NI 81-104. We are proposing that alternative funds comply with the same requirements applicable to other mutual funds under Part 3 of NI 81-102. The biggest change would be that the seed capital requirement for alternative funds would increase from $50,000 (the minimum seed capital requirement currently applicable to commodity pools) to $150,000. Furthermore, rather than the manager having to maintain a $50,000 investment in the fund (as currently required for commodity pools), the manager of an alternative fund may redeem the seed capital once the fund has raised at least $500,000 from outside investors. The proposed changes to the seed capital requirements are consistent with feedback received during CSA's consultations and with exemptive relief that has been granted to a number of existing commodity pools.

(iv) Proficiency

Currently, Part 4 of NI 81-104 requires a "mutual fund restricted individual" (as defined in NI 81-104)[2] who sells commodity pool securities to have qualifications that go beyond the minimum requirements to be registered as a dealing representative of a mutual fund dealer (the Proficiency Requirements). Specifically, a mutual fund restricted individual may only trade in a security of a commodity pool if that individual meets the additional proficiency standards set out in subsection 4.1(1) of NI 81-104. Part 4 also imposes proficiency requirements for dealer supervision of trades in commodity pool securities. There are currently no additional requirements for individuals registered as dealing representatives of an investment dealer who are also members of the Investment Industry Regulatory Organization of Canada (IIROC).

Consistent with the approach taken with proficiency requirements for registrants generally, we are of the view that the Proficiency Requirements would be best addressed through the existing registrant regulatory regime as opposed to following the NI 81-104 approach of incorporating such requirements into an operational rule for investment funds. For example, subsection 3.4(1) of National Instrument 31-103 *Registrant Requirements, Exemptions and Ongoing Registrant Obligations* establishes a general proficiency principle for all registrants, which states "[a]n individual must not perform an activity that requires registration unless the individual has the education, training and experience that a reasonable person would consider necessary to perform the activity competently[.]" In addition, the Proficiency Requirements are duplicative with similar requirements in existing MFDA rules and policies. As a result, we are not proposing to move the Proficiency Requirements into NI 81-102 as part of the Proposed Amendments.

Given the unique features that will characterize alternative funds, such as the increased flexibility to create leverage and engage in potentially more complex strategies, the CSA recognize that it will be appropriate for additional education, training and experience requirements to apply to

[2] This term is generally intended to refer to a person registered as a mutual fund dealer. In all jurisdictions in Canada except Quebec, mutual fund dealers are also members of the Mutual Fund Dealers Association of Canada (the MFDA).

individual mutual fund dealing representatives who sell alternative funds. On this basis, it is reasonable to consider whether, in order to satisfy the general proficiency principle that applies to all registrants, specific training would be necessary for an individual dealing representative to understand the structure, features, and risks of any alternative fund securities that he or she may recommend. From this perspective, we are engaging with the MFDA in order to determine the appropriate proficiency requirements for dealing representatives of mutual fund dealers trading in securities of Alternative Funds. This work will be parallel to our ongoing work with the Proposed Amendments and we will ensure that it has been completed before the Proposed Amendments would come into force. We also note the CSA's ongoing consultations with respect to the proposals to enhance the obligations of dealers and representatives generally, as outlined in CSA Consultation Paper 33-404 *Proposals to Enhance the Obligations of Adviser, Dealers, and Representatives Towards Their Clients*, which will also inform our work in this regard.

(v) Disclosure

Form of Prospectus/Point of Sale

A key element of the CSA's proposal for a more robust framework for alternative funds is to also bring alternative funds into the prospectus regime that exists for other types of mutual funds.

Currently, under NI 81-101, all mutual funds, other than commodity pools and exchange listed mutual funds, are required to prepare an SP, annual information form (AIF) and Fund Facts, with the Fund Facts having to be delivered at or before the point of sale. We are proposing that alternative funds that are not listed on an exchange be subject to this disclosure regime.

All other types of mutual funds, including commodity pools and exchange listed mutual funds, as well as non-redeemable investment funds, are required to file a long form prospectus under Form 41-101F2, which is delivered under the standard prospectus delivery period of within 2 days of the trade.

The CSA are currently finalizing amendments to implement a summary disclosure document similar to the Fund Facts, called ETF Facts, that will be prepared in respect of mutual funds that are listed on an exchange. It is expected that these provisions will also be applicable to listed alternative funds.

Given the CSA's efforts to otherwise harmonize the disclosure regimes for mutual funds, we do not believe that there is a policy basis for requiring that unlisted alternative funds continue to be subject to a different prospectus regime than every other type of unlisted mutual fund.

In connection with this we are also proposing changes to the Fund Facts to provide additional disclosure requirements for alternative funds. These changes would consist of requiring text box disclosure that would clearly highlight how the alternative fund differs from other mutual funds in terms of its investment strategies and the assets it is permitted to invest in. It is anticipated that complementary changes will also be reflected in the ETF Facts form requirements once they come into effect.

We are also proposing consequential amendments to Form 41-101F2 to remove any references to commodity pools.

Financial Statement Disclosure

Currently, Part 8 of NI 81-104 requires commodity pools to include in their interim financial reports and annual financial statements disclosure regarding their actual use of leverage over the period referenced in the financial statements (the Leverage Disclosure Requirements). In connection with the repeal of NI 81-104, we are proposing to incorporate the Leverage Disclosure Requirements into NI 81-106, with the requirement that it apply to any investment fund that uses leverage, which would therefore apply this requirement to non-redeemable investment funds as well. We are also proposing that the Leverage Disclosure Requirement apply to disclosure in an investment fund's Management Report of Fund Performance. NI 81-106 is the Instrument that sets out the applicable continuous disclosure requirements for investment funds, so it was appropriate to propose that the Leverage Disclosure Requirements be moved to that Instrument

(vi) Other Changes

Except as modified or repealed as referenced above, in connection with the repeal of NI 81-104, all the provisions in that instrument that currently apply to commodity pools, would be integrated into NI 81-102 and would apply to alternative funds.

(vii) Transition/Coming into Force

Subject to the nature of comments we receive, as well as any applicable regulatory requirements, we are proposing that if approved , the Proposed Amendments would come into force approximately 3 months after the final publication date, and would immediately apply to any investment fund that files a preliminary prospectus after that date. This will also apply to funds that filed a preliminary prospectus before the coming into force date but have not yet filed a final prospectus as of that date.

We recognize that for existing funds, a longer transition period may be needed to make the necessary adjustments to their portfolio as well as to their compliance and operational systems. Accordingly, we are proposing that for existing funds, the Proposed Amendments not apply for an additional 6 months after the coming into force date of the Proposed Amendments, provided that the fund filed its final prospectus before the coming into force date. We are also proposing that the Fund Facts pre-sale delivery requirements for existing funds will not apply for an additional 6 months from the coming into force date of the Proposed Amendments.

Adoption Procedures

We expect the Proposed Amendments to be incorporated as part of rules in each of British Columbia, Alberta, Manitoba, Ontario, Nova Scotia, Prince Edward Island, New Brunswick, Newfoundland and Labrador, Northwest Territories, Yukon and Nunavut, and incorporated as part of commission regulations in Saskatchewan and regulations in Québec. The Proposed

81-102 CP Changes are expected to be adopted as part of policies in each of the CSA jurisdictions.

Alternatives Considered to the Proposed Amendments

An alternative to the Proposed Amendments would be to not implement any changes to regulatory regime governing commodity pools and maintaining the status quo.

Not proceeding with the Proposed Amendments would restrict the potential growth of commodity pools/alternative funds by limiting their ability to get exposure to new asset classes or to adopt new strategies, particularly those used by so-called "liquid alt" funds, that are commonplace in other jurisdictions for investment fund products sold to retail investors. While some of these strategies may be riskier, many are also designed to mitigate market risk, take advantage of market inefficiencies or to help produce more consistent returns under various market conditions. Alternative investment strategies have historically only been available in Canada to accredited investors or other types of investors eligible to purchase securities without a prospectus. The Proposed Amendments would enhance the offering of alternative funds and strategies by setting an appropriate regulatory framework in which these strategies may be used in funds sold by prospectus. We think that not proceeding with the Proposed Amendments would stifle innovation in the marketplace to the detriment of both investors and the investment funds industry.

As well, the prospectus regime for commodity pools would continue to be out of step with regulatory developments impacting the prospectus regime for other types of mutual funds.

Not proceeding with the Proposed Amendments in respect of the Interrelated Investment Restrictions would not be appropriate in view of both investor protection and fairness concerns, since this would permit some non-redeemable investment funds to potentially operate in a manner that is inconsistent with other investment funds. The Interrelated Investment Restrictions are intended to create a more consistent, fair and functional regulatory regime across the spectrum of publicly offered investment fund products.

Anticipated Costs and Benefits of the Proposed Amendments

We think the Proposed Amendments strike the right balance between protecting investors and fostering fair and efficient capital markets. The Proposed Amendments would benefit investors and the capital markets by encouraging product innovation and permit Canadians to gain exposure to investment strategies that have been employed for retail fund products around the world, while still maintain the protections that recognize that these products are being sold to retail investors.

The CSA are of the view that the Proposed Amendments would not create substantial costs for investment funds, their managers or securityholders. Many of the Proposed Amendments codify exemptive relief routinely granted, or expand prevailing investment parameters and limits currently applicable to mutual funds and commodity pools.

While some of the Proposed Amendments would impose restrictions on non-redeemable investment funds that are not currently in place, our review of non-redeemable investment funds from the earlier stages of this Phase of the Modernization Project indicated that a large majority of non-redeemable investment funds follow investment restrictions that are comparable to the proposed Interrelated Investment Restrictions. Further, many managers either manage various types of investment fund products (including mutual funds subject to NI 81-102) or have already established the necessary infrastructure to monitor compliance with the investment restrictions included in the constating documents of their funds. As a result, these managers are already equipped to monitor compliance with any additional investment restrictions. Therefore, we do not believe that the proposed Interrelated Investment Restrictions would create substantial costs for non-redeemable investment funds.

Overall, we think the potential benefits of the Proposed Amendments are proportionate to their costs. We seek feedback on whether you agree or disagree with our perspective on the cost burden of the Proposed Amendments. Specific quantitative data in support of your views in this context would be particularly helpful.

Local Matters

Annex I is being published in any local jurisdiction that is making related changes to local securities laws, including local notices or other policy instruments in that jurisdiction. It also includes any additional information that is relevant to that jurisdiction only.

Unpublished Materials

In developing the Proposed Provisions, we have not relied on any significant unpublished study, report or other written materials.

Request for Comments and Feedback

We are soliciting comment on the Proposed Amendments. While welcome comments on any aspect of the proposal, we have also identified specific issues for comment in Annex A to this Notice.

We cannot keep submissions confidential because securities legislation in certain provinces requires publication of a summary of the written comments received during the comment period. All comments will be posted on the websites of each of the Ontario Securities Commission at www.osc.gov.on.ca, the Alberta Securities Commission at www.albertasecurities.com and the Autorité des marches financiers at www.lautorite.qc.ca. Therefore, you should not include personal information directly in comments to be published. It is important you state on whose behalf you are making the submissions.

Please submit your comments in writing on or before December 22, 2016. If you are not sending your comments by email, please send a CD containing the submissions in Microsoft Word format.

Please note that some CSA jurisdictions may also host roundtables to discuss the Proposed Amendments and we encourage interested stakeholders to participate.

Where to Send Your Comments

Address your submission to all of the CSA as follows:

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

Please send your comments only to the addresses below. Your comments will be forwarded to the other CSA members.

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Toronto, Ontario M5H 3S8
Fax: 416-593-2318
Email: comments@osc.gov.on.ca

Me Anne-Marie Beaudoin
Corporate Secretary
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Questions

Please refer your questions to any of the following CSA staff:

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Contents of Annexes

The text of the Proposed Amendments is contained in the following annexes to this Notice and is available on the websites of members of the CSA:

Annex A – Specific Questions of the CSA Relating to the Proposed Amendments

Annex B – Summary of Public Comments and CSA Responses on the 2013 Alternative Funds Proposal.

Annex C-1 – Proposed Repeal of National Instrument 81-104 *Commodity Pools*

Annex C-2 - Proposed Withdrawal of Companion Policy 81-104CP to National Instrument 81-104 *Commodity Pools*

Annex D-1 - Proposed Amendments to National Instrument 81-102 *Investment Funds*

Annex D-2 – Blackline of National Instrument 81-102 *Investment Funds* to Highlight the Proposed Amendments

Annex D-3 - Proposed Changes to Companion Policy 81-102CP to National Instrument 81-102 *Investment Funds*

Annex E – Proposed Amendments to National Instrument 81-106 *Investment Fund Continuous Disclosure*

Annex F – Proposed Amendments to National Instrument 81-107 *Independent Review Committee for Investment Funds*

Annex G - Proposed Amendments to National Instrument 81-101 *Mutual Fund Prospectus Disclosure*

Annex H – Proposed Amendments to National Instrument 41-101 *General Prospectus Requirements*

Annex I – Local Matters

Annex A

Specific Questions of the CSA relating to the Proposed Amendments

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 "non-conventional mutual fund" better reflect these types of 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.

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.

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.

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.

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*).**

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.

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.

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.

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?

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.

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.

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.

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?

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.

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.

Annex B

SUMMARY OF PUBLIC COMMENTS AND CSA RESPONSES ON THE 2013 ALTERNATIVE FUNDS PROPOSAL AND THE INTERRELATED INVESTMENT RESTRICTIONS

Table of Contents	
PART	**TITLE**
Part I	**Background**
Part II	**Comments on proposed alternative fund framework**
Part III	**Comments on proposed interrelated investment restrictions**
Part IV	**List of commenters**

Part I – Background

Summary of Comments

On March 27, 2013, the Canadian Securities Administrators (CSA) published proposals relating to the second phase of the Modernization of Investment Fund Product Regulation Project (the Modernization Project). The proposals included amendments to National Instrument 81-102 *Mutual Funds* (NI 81-102), changes to Companion Policy 81-102CP (81-102CP), related consequential amendments, and proposals relating to National Instrument 81-104 *Commodity Pools* (NI 81-104) and securities lending, repurchases and reverse repurchases by investment funds (collectively, the Proposals). On June 25, 2013, the CSA published CSA Staff Notice 11-324 *Extension of Comment Period* (CSA Staff Notice 11-324) to extend the closing of the comment period on the Proposals from June 25, 2013 to August 23, 2013.

The Proposals included an outline of a more comprehensive regulatory framework for alternative funds (the Alternative Funds Proposals). The Alternative Funds Proposal aimed to (i) introduce core investment restrictions and operational requirements for publicly offered non-redeemable investment funds, other than scholarship plans, (ii) enhance the disclosure requirements relating to securities lending, repurchases and reverse repurchases by investment funds and (iii) create a more comprehensive alternative fund framework to be effected through amendments to NI 81-104 (the Alternative Funds Proposal).

On June 19, 2014, the CSA published final amendments that introduced core investment restrictions and operational requirements for non-redeemable investment funds and new disclosure requirements with respect to securities lending by all investment funds (the June 2014 Amendments), which substantially came into force on September 22, 2014, with the final transitional provisions coming into force in March of 2016.

As was described in CSA Staff Notice 11-324, the Alternative Funds Proposal were being considered in conjunction with certain of the investment restrictions included in the Proposals and separately from the June 2014 Amendments. As a result, the CSA did not summarize comments on the Alternative Funds Proposal or certain proposed amendments regarding investments in physical commodities, borrowing cash, short selling and use of derivatives (the Interrelated Investment Restrictions) in the Summary of Public Comments And CSA Responses published with the June 2014 Amendments.

We have instead chosen to summarize the comments we received on the Alternative Funds Proposal and on the Interrelated Investment Restrictions in connection with the current Notice and Proposed Amendments, in part to reflect that these earlier comments helped to inform our efforts in preparing the Proposed Amendments for consideration.

We received submissions from 36 commenters in relation to the Alternative Funds Proposal and the Interrelated Investment Restrictions, which are listed in Part IV. We wish to thank all those who took the time to comment.

Part II - Comments on proposed alternative fund framework

Issue	**Comments**	**Responses**
General comments	Many commenters stated that in order to properly evaluate the CSA's proposals with respect to non-redeemable investment funds, the CSA would need to publish further detail regarding the Alternative Funds Proposals. Additionally, any reforms to the investment restrictions applicable to non-redeemable investment funds should be undertaken in connection with the development of the Alternative Funds Proposals.	We acknowledge this concern and have published the Proposed Amendments for comment. We welcome any specific feedback on the proposals contained therein.

	Several commenters agreed with the concept of an Alternative Funds Proposals and thought such a regulatory regime would create opportunities for alternative fund managers and increased investment options for retail investors.	We agree and acknowledge that is consistent with the intent behind the Proposed Amendments.
	Two commenters expressed concern that the Alternative Funds Proposals would create barriers to entry for alternative funds and result in these funds being labeled as high risk.	We believe that the Proposed Amendments will address this concern but welcome any specific feedback in this regard.
	One commenter is of the view the creation of a category of investment funds which are "alternative funds" and which allow alternative investment strategies which present, in general, much greater complexity and higher risk, should, at a minimum, only be permitted if clear labeling is required, in the name of the fund itself (and the category) which makes the complexity and higher risk of this category of funds abundantly clear to retail investors.	The Proposed Amendments do include disclosure requirements that will highlight the differences between alternative funds and other more conventional mutual funds in terms of strategies and investments. The required risk disclosure will be consistent with that of any other type of investment fund. We are not proposing a naming convention for alternative funds under the Proposed Amendments.
	Two commenters encouraged the CSA to adopt a purposive or principles based framework rather than a prescriptive approach to the Alternative Funds Proposals to allow Canadian investors access to as many different types of alternative funds as possible.	The Proposed Amendments are intended to fit within the existing regulatory framework for investment funds and therefore the approach taken with regards to prescriptive vs principles-based is consistent with the present regulatory regime.
	One commenter stated that it is important to harmonize regulation for products perceived by the public as belonging to the same category of risk and liquidity as mutual funds. This prevents regulatory arbitrage and mis-selling. Although where products are different and satisfy different investor needs, the best way to differentiate products is to ensure that there is a clear	The existing regulatory framework provides specific provisions for different types of investment fund products such as conventional mutual funds, conventional mutual funds traded on an exchange, money market funds, non-redeemable investment funds or other specialized funds including scholarship plans,

	articulated difference in their structure. Products should be clearly separated based on structural factors such as whether they are redeemable or exchange listed. This would better help investors than creating different investment restrictions on the same types of funds depending on whether they are conventional or alternative.	labour-sponsored investment funds, and commodity pools. The Proposed Amendments are intended to fit within the current framework.
	One commenter recommended that the CSA consider similar reforms, such as risk labelling of products or banning certain product features sold to retail investors in order to adequately protect investors. While disclosure is a necessary aspect of securities regulation, it alone will not provide adequate protection to retail investors	We agree that disclosure alone will not provide adequate protection to investors. While the Proposed Amendments do expand the range of investment strategies available to alternative funds, it also imposes what we consider reasonable restrictions to reflect that these funds that are distributed to the public. The Proposed Amendments will also address matters concerning dealer proficiency and we welcome any feedback in this regard.
	One commenter stated that minor deviations from the investment restrictions in NI 81-102, should not necessitate a fund being regulated by the alternative funds regime. The commenter asked CSA to clarify that they are not intending to force mutual funds currently investing in reliance of relief from NI 81-102 to transition to the alterative fund regulatory regime.	We agree. The Proposed Amendments include codification of exemptive relief that has been routinely granted to mutual funds, and this has been accounted for in considering the range of provisions applicable to alternative funds or non-redeemable investment funds vs mutual funds. As such, we do not believe that it will force mutual funds to become alternative funds, or otherwise create any overlap between the two types of funds. However, we welcome any feedback where this concern may be identified.
	One commenter stated that the CSA appears to have a presumption that alternative funds are more risky than conventional funds, but that this is not the case for all alternative funds.	We agree that this is not always the case and believe the Proposed Amendments do not necessarily have this presumption, but welcome any feedback in this regard.

Definition of Alternative Fund	A commenter expressed concerned that the use of the term alternative fund could be interpreted to mean these funds are high risk or volatile and that it may lead to confusion or preclude privately offered funds from utilizing the term alternative in their names.	We understand the concern. Under the Proposed Amendments, the term "alternative fund" will be used for descriptive purposes to reflect that these funds are permitted to engage in certain strategies or invest in asset classes that are not permitted for more conventional mutual funds. We are not proposing any mandatory naming conventions or other labelling requirements. We are also proposing to remove the warning label language currently applicable to commodity pools under Form 41-101F2 because we recognize that not all alternative funds or strategies are inherently riskier than a conventional mutual fund. However, we are seeking feedback as to whether we should consider a different defined term to describe these types of funds.
	One commenter throught a term based on the structure of a product would better assist investors.	Under the Proposed Amendments, the term "alternative fund" will only be applied to mutual funds, and reflects that they can engage in strategies not necessarily available to more conventional mutual funds.
	Another commenter suggested that such funds be called "Risk-Magnified Funds", "Higher-Risk Funds" or some other term that sets out clearly that such funds carry increased risks, as compared to conventional non-redeemable and mutual funds.	We did not propose a naming convention under the Proposed Amendments, the Propose Amendments provide tailored disclose for Alternative Funds that will highlight how alternative funds differ from other conventional mutual funds in terms of the investment strategies and asset classes it is permitted to invest in.
	Two commenters believed the term alternative fund provided an appropriate description of the types of investment funds that should be captured by NI 81-104.	We agree this term will better describe the types of investment objectives and strategies that characterize these types of funds.

	A commenter felt that fixed portfolio ETFs (as defined in NI 81-102) should not automatically be considered alternative funds.	Fixed portfolio ETFs will not automatically be considered alternative fund under the Proposed Amendments. We do note however, that this term is being replaced by the term "fixed portfolio investment fund", but this change will not impact whether or not these funds are considered alternative funds.
Concentration restrictions	One commenter stated the imposition of restrictions on selected aspects of investment fund strategies may impair these strategies without achieving the objective of increased investor protection. However the commenter supported the use of balanced restrictions that will enhance investor protection while permitting funds sufficient latitude to effectively execute their investment strategies.	We believe the Proposed Amendments provide a good balance between investor protection and an effective framework for alternative funds offered to the public.
	Several commenters felt there is no need for a concentration restriction applicable to alternative funds.	We do not agree that there should be no concentration limits. Under the Proposed Amendments, alternative funds will be considered to be mutual funds, a defining feature of which is the ability to redeem securities at their net asset value. Excessive concentration of a mutual fund's portfolio in a single issuer can impact a fund's ability to meet regular redemption requests.
	A few commenters suggested that an appropriate concentration restriction for alternative funds could be set using a threshold of 20% of total assets or net assets.	We are proposing to increase the concentration limits for alternative funds to 20% of NAV. We welcome any specific comments as to whether this is sufficient or not.
	Two commenters maintained that disclosure of the additional risks associated with a less diverse portfolio would be sufficient.	We believe the usual requirements regarding risk disclosure in an investment fund's prospectus will allow for sufficient disclosure of the risks connected with the concentration limits for alternative funds under the Proposed Amendments.

	A commenter felt that fixed portfolio ETFs (as defined in NI 81-102), which may make concentrated investments in one or more issuers, should not automatically be considered alternative funds.	Under the Proposed Amendments, fixed portfolio ETFs will not automatically be considered alternative funds. We also note that we are proposing to replace that term with the term "fixed portfolio investment fund", but that this change will not impact whether or not a fixed portfolio ETF that is a mutual fund will be considered an alternative fund.
	One commenter believed it would be appropriate for an alternative fund to be permitted to invest up to 30% of its net asset value in a single issuer and, perhaps as an additional control, to limit an alternative fund to investing no more than 50% of its net asset value, in aggregate, in holdings that exceed 10% of the fund's net asset value.	Under the Proposed Amendments, the concentration limits applicable to an alternative fund will be 20% of net asset value, but we are not proposing any other specific concentration limits. We welcome feedback as to whether or not this is sufficient.
	One commenter advised that flow-through limited partnerships will often invest more than 10% of their net assets in securities of a single issuer.	We note that flow-through limited partnerships will not be alternative funds under the Proposed Amendments as these types of funds are typically non-redeemable investment funds. The proposed higher concentration limit of 20% will also apply to non-redeemable investment funds. That said we welcome any feedback regarding any specific hardships on certain types of funds that may result from the Proposed Amendments.
Measurement of concentration where investments are leveraged	One commenter expressed the view that leverage cannot be examined in a vacuum and that liquidity of an investment fund's portfolio is more important than the fund's use of leverage from a risk management prospective.	Thank you for the comment. We welcome feedback on the leverage provisions within the Proposed Amendments.
	Another commenter stated the current leverage measurement requirements based on net asset value provide accurate information about the concentration of	Under the Proposed Amendments, the proposed methodology for measuring leverage will be based on NAV.

	a fund's portfolio. A couple commenters stated that if a concentration restriction were to be put in place, total notional exposure would be the appropriate measurement.	The Proposed Amendments contemplate using notional exposure to calculate leverage created by derivatives. The concentration provisions in NI 81-102 have always contemplated a look through test that considers indirect exposure through derivatives or investment in underlying funds and will continue to do so under the Proposed Amendments.
Borrowing restrictions	A few commenters thought it is necessary that a borrowing limit should take into account whether the securities of the fund are redeemable or that funds should be required to match their redemption terms to the liquidity of their investments.	Under the Proposed Amendments we decided on only one borrowing limit for alternative funds and non-redeemable investment funds, without consideration of redemption frequency. We are comfortable that the requirements will not impede a fund's ability to meet its redemptions, as borrowing will be limited to no more than 50% of a fund's NAV, when combined with any short-selling by the fund. The fund will still have to manage its portfolio in order to meet its redemption requirements consistent with NI 81-102. We welcome any specific feedback in this regard.
	One commenter believed that alternative funds should have a higher borrowing limit than conventional funds.	We agree and the Proposed Amendments reflect this view.
	One commenter thought that borrowing from prime brokers would facilitate alternative fund investment strategies. The requirements prime brokers typically impose with respect to liquidity, leverage and capital will restrict the use of borrowing by funds.	Under the Proposed Amendments, alternative funds would be permitted to borrow from an entity that would qualify as a custodian pursuant to section 6.2 of NI 81-102. This includes would include dealers that act as prime brokers in Canada. We welcome any specific feedback in this regard.

	A Commenter believed where an alternative fund invests outside of Canada it may be advantageous for the fund to borrow from a local lender. Two commenters stated alternative funds or non-redeemable funds should not be subject to any restriction on borrowing. The determination of the adequate leverage ratio for these funds should be left to the direction of fund managers.	The Proposed Amendments do not contemplate permitting alternative funds to borrow from non-Canadian lenders. However, we welcome specific submissions on this issue. We do not agree that there should be no limit on borrowing or leverage for alternative funds that can be sold to retail investors and have proposed limits on borrowing that we believe strike a reasonable balance between encouraging innovative strategies and limiting the risk to the funds from excessive leverage. We note that it is common in many international jurisdictions to impose borrowing limits on publicly distributed mutual funds.
Short selling restrictions	Several commenters thought alternative funds should have increased flexibility to engage in short selling. Many commenters expressed that the NI 81-102 investment restrictions that apply to short selling would impair the ability of alternative funds to utilize many common investment strategies. In particular, the cash cover requirements would prevent these funds from continuing to use common investment strategies.	We agree. The Proposed Amendments provide alternative funds with greater flexibility to engage in short selling. For example: • A larger portion of an alternative fund's portfolio can be sold short • A larger portion of a single issuer's securities can be sold short • We are proposing to remove the restrictions on the use of proceeds from short sales • We are removing the cash cover requirements (though short selling will fall within the overall leverage limits applicable to alternative funds). Please see the response above.

	One commenter believed a blanket short selling limit of 40% of NAV may be acceptable where short selling for market hedging purposes (as defined by IIROC) is not included in the calculation of an alternatives fund's short selling for the purposes of compliance with the limit.	Please see the response above. The Proposed Amendments do not contemplate an exemption for hedging transactions for the short selling limit.
	One commenter maintained that short selling of government bonds should be exempt from restrictions on short selling.	We are not proposing to exempt new type of securities from the short-selling restrictions at this time, but welcome any feedback on whether certain exemptions may be appropriate.
	One commenter stated that short selling is essential to alternative fund strategies.	We understand and believe the Proposed Amendments reflects this.
	One commenter recommended the aggregate market value of securities of any one issuer that may be sold short by an alternative fund should be limited to 20% of the NAV of the fund and that the aggregate market value of all securities that may be sold short by an alternative fund should be limited to 100% of the NAV of the fund.	Please see above. We have not proposed that the short-selling provisions in the Proposed Amendments go this far. We think the limits proposed therein are a reasonable place to start. We welcome any feedback on whether or not the short-selling provisions are sufficient.
	A commenter thought allowing alternative funds to fully hedge out their long positions through equivalent short positions may also allow managers to tactically reduce portfolio volatility where they see potential downside risks to the market.	Please see above.
Leveraged daily tracking funds	A commenter stated that leveraged daily tracking alternative funds are highly volatile and clearly not appropriate for many investors. The commenter is of the view that many of the trades in these securities are	Thank you for the comment. We agree that investor education is very important, particularly with respect to products with the potential for high volatility such as leverage daily tracking funds. A number of CSA

	done through discount brokerages where the proficiency of the registered representatives is not an issue, but the proficiency of the investor is a greater concern. The commenter believes that additional regulation may not be of assistance, but increased investor education is strongly recommended. Another commenter referred to disciplinary cases and cases before the Ombudsman for Banking Services and Investments where leveraged daily tracking funds have been sold to retail investors for whom they were not suitable. One commenter believed that the existing regulatory regime mandates sufficient proficiency for the marketing and sale of alternative funds, including leveraged daily tracking funds.	members have made considerable efforts over the last years to improve investor education material on their websites In addition, a key element of the Proposed Amendments is to also bring alternative funds into the prospectus regime that exists for other type of mutual funds, including the requirement to prepare a fund facts document. We are proposing that Alternative Funds provide additional disclosure in their fund facts documents. These changes will amount to required text box disclosure that will clearly highlight how the alternative fund differs from other conventional mutual funds in terms of investment strategies. Please see our responses below relating to proficiency standards for mutual fund restricted individuals dealing in Alternative Funds

Counterparty credit exposure	A few commenters thought it would not be appropriate to repeal the exemption for commodity pools from the counterparty exposure limit provisions of subsection 2.7(4) of NI 81-102 (the **Counterparty Exposure Exemption**) from NI 81-104 and that maintaining the exemption would allow alternative funds to operate more efficiently. A number of commenters believed that imposing mandatory posting of collateral on a mark-to-market basis would be more appropriate. Requiring a counterparty to post collateral that is segregated from the other assets of the fund would mitigate risk. In addition, the CSA should consider imposing requirements as to the nature of the collateral that should be posted. One commenter stated that counterparty risk is a significant issue for more than just the alternative funds sector. Rules on counterparty exposure should be consistent with other CSA rules on counterparties. Two commenters thought that central clearing requirements for derivative transactions would reduce the use of OTC derivatives by investment funds, but a restriction limiting unsecured exposure to any one counterparty would mitigate risk.	The Proposed Amendments do include a repeal of the exemption for commodity pools from the counterparty exposure limit provisions of subsection 2.7(4) of NI 81-102 (the Counterparty Exposure Exemption), as well as introducing an exemption from the counterparty credit rating provisions in subsection 2.7(1) of NI 81-102 for alternative funds. This was seen as way to offer alternative funds more options in terms of counterparties to work with (as we understand that there are now fewer counterparties that would meet the "designated rating" threshold required under subsection 2.7(1) of NI 81-102, while at the same time mitigating counterparty risk by limiting a fund's exposure to any one counterparty. We welcome any specific feedback or commentary on other options that may more effectively help achieve the same goal. Under the Proposed Amendments, the counterparty exposure limits in subsection 2.7(4) will apply to all investment funds, except in the case of specified derivatives that have been centrally cleared. The CSA currently has proposals out for comment to implement a mandatory central clearing regime for certain types of derivatives transactions, similar to regimes implemented in other jurisdictions around the world. The Proposed Amendments contemplate an exemption from the counterparty credit limit provisions of subsection 2.7(1) of NI 81-102 and the counterparty exposure limits of subsection 2.7(4) of NI 81-102 for derivatives transactions that are executed through a central clearing house that is registered with the applicable regulatory agency.

	One commenter said an example of an operational efficiency that would likely not be available to alternative funds under a regime where the Counterparty Exposure Exemption was unavailable is alternative funds' use of clearing brokers. Many alternative funds use clearing brokers to help settle derivatives trades and net out exposures to what would otherwise be multiple counterparties. In this arrangement, the clearing broker acts as a counterparty to the fund and provides significant simplification with respect to negotiations with and monitoring of executing parties.	Please see above.
	A commenter thought it may also be difficult, given the relatively small size of the Canadian market and the challenges that Canadian alternative funds may face in accessing large numbers of counterparties, for alternative funds to observe a 10% counterparty exposure limit.	Please see above. As part of the Proposed Amendments, we are proposing to loosen the requirements for alternative funds, to only engage with counterparties that have a "designated rating", with the intent that this will open up the range of counterparties with whom they can transact.
	One commenter did not believe that the Counterparty Exposure Exemption should be repealed because it is not clear that there is any risk from single counterparty exposure that needs to be mitigated.	Please see above. We welcome any specific feedback in this regard.

Total leverage limit	Two commenters stated the use of leverage by an investment fund does not necessarily mean that such a fund would be riskier than a fund that does not employ leverage.	While leverage itself may not necessarily make a fund riskier than one that does not use leverage, it does have the potential to magnify the potential loss in a way that an unlevered fund will not. As such, we believe that it is appropriate to set limits on the use of leverage by investment funds and to have those funds disclose their leverage, both of which are part of the Proposed Amendments.
	One commenter believes the appropriate overall leverage limit for an alternative fund would depend on a number of factors, including the volatility of the fund's investments, risk parameters imposed by the manager, the liquidity of the fund's portfolio and how quickly the fund can de-lever. The commenter supported the general principle of an overall leverage limit which accommodates as many different types of alternative funds as possible.	Under the Proposed Amendments, we are proposing a single leverage limit for all alternative funds, to be calculated in the same way. We believe this will assist in investor in understanding and comparing leverage use by different funds.
	A commenter believed the calculation of the overall leverage of a fund should exclude hedging positions and positions in sovereign debt and associated currencies.	We have not proposed to allow for any exclusions in calculating total leverage under the Proposed Amendments – this is consistent with how funds are currently expected to calculate their maximum use of leverage under Form 41-101F2. As well, hedging transactions do not necessarily fully offset the risk of the initial position – a full exclusion of any hedging transaction may obscure a fund's true leverage by assuming the hedged position creates an offset that may not actually be the case. However, we do welcome any additional feedback on these proposals.

	A few commenters suggested that the UCITS model for regulated alternative funds provides for more practical and meaningful ways of controlling risk than imposing an absolute limit on leverage or notional exposure. The CSA should consider liquidity, borrowing, VAR and diversification limits.	Thank for you the comment. We are aware of the UCITS model and note that NI 81-102 both currently and under the Proposed Amendments, incorporates many similar elements. We are also seeking comments on the flexibility and convenience of using the gross notional exposure.
	One commenter felt it would be dangerous to monitor or regulate the risk of an alternative fund by limiting leverage or solely through a leverage limit.	We agree and are not proposing to do so under the Proposed Amendments, which also include limits on the use of borrowing and short selling, independent of the overall leverage limit being proposed.
	A commenter suggested the CSA should focus on margin to equity ratios rather than leverage.	Thank you for the comment. The method we are proposing is intended to be a simple and consistent method to calculate total leverage across different types of alternative funds. The margin to equity ratio may be inconsistent across different funds and different periods. Required margins may vary from one derivative product to another as well as from one period to the next. We welcome any further comment in this regard.
	Another commenter agreed that a limit of 3:1 seems reasonable for alternative funds that are not mutual funds. For mutual funds, the total limit should be lower. The combination of illiquid assets and leverage may create further problems for mutual funds.	We agree and this is reflected in the Proposed Amendments which contemplate a 3:1 leverage ratio for alternative funds and non-redeemable investment funds.
	One commenter believed exemptions from a total leverage limit should be considered on a case-by-case basis.	Considering leverage on a case-by-case basis is largely impractical from a rule-making standpoint. However, we note that the Proposed Amendments will not derogate from an issuer's ability to seek exemptive

		relief from any provision of NI 81-102.
	Another commenter proposed a total leverage limit of no more than 4:1 as an absolute limit and would suggest that 3:1 be set as the maximum at the time of investment, which would provide flexibility to account for market fluctuations.	We have proposed a hard limit of 3:1 leverage under the Proposed Amendments as we want leverage to be monitored on a daily basis and not just at the time of investment. However, we welcome any feedback regarding whether or not this is unduly flexible for issuers.
	A few commenters expressed the view that a total leverage limit for funds that offer redemptions should be lower.	We believe the proposed 3:1 leverage limit is appropriate for alternative funds and non-redeemable investment fund and have not decided to set different limits based on whether a fund offers redemptions. This in part reflects the fact that the availability of redemptions is not much of a distinguishing feature between alternative funds (which under the Proposed Amendments will be mutual funds) and non-redeemable investment funds, as a large proportion of them also offer redemptions at NAV on a yearly basis.
	One commenter felt alternative funds should be subject to a total leverage limit, whether it is 3x as proposed by the CSA or slightly higher, i.e. 4x. This will provide baseline protection for retail investors from highly levered products that are not appropriate even under the alternative fund framework.	We agree and this is reflected in the Proposed Amendments.
	Another commenter stated that while the proposed level of absolute leverage at 3 to 1 is an appropriate starting point, it is important to ensure that overall levels of risk remain acceptable at the portfolio level.	Thank you for the comment. We note that NI 81-102, both currently and under the Proposed Amendments, incorporates many provisions to address risks at the portfolio level. We welcome any feedback or commentary in this regard.

	One commenter believed NI 81-104 should not impose any restrictions on leverage for alternative investment funds. And that NI 81-104 should provide for a truly alternative regime that will permit for a range of investment strategies that are required in order to meet investors' needs.	We do not agree that alternative funds that can be sold to retail investors should have unrestricted leverage. We further note that this view is consistent with international regulation of similar products.
Measurement of leverage	A few commenters thought the current measurement of leverage as long position plus short positions over net asset value should be changed. Short positions entered into for hedging purposes should be subtracted from long positions.	Please see our response to a similar comment above. The Proposed Amendments do not contemplate an exemption for hedging or netting transactions for the leverage calculations.
	One commenter believed the definition of leverage must be altered to allow alternative funds to employ meaningful risk mitigation techniques.	Please see our response above. Under the Proposed Amendments, leverage can be created by cash borrowing, short selling and derivatives. Managers can employ risk mitigation techniques as long as they are permitted under NI 81-102, both currently and under the Proposed Amendments.
	Another commenter felt disclosure should illustrate the effect of heightened volatility that is caused by leverage. This would illustrate the costs of leverage and provide a better sense of the potential risks. However, such a proposal would require developing reasonable assumptions regarding underling asset volatility and cost of leverage over time.	We thank you for your comment and welcome specific feedback in this regard.
	One commenter stated that it may be appropriate to measure leverage in conjunction with net exposure where strategies may look to achieve gross leverage levels in excess of 3 to 1. A limitation of net leverage (such as limiting net market exposures in a leveraged	Please see our response to similar comments above. In addition, we believe a limitation on net leverage may be ineffective in accurately demonstrating a fund's level of leverage since the net exposure calculation does not distinguish leveraged positions from

	portfolio) where leverage exceeds 3x may be appropriate; however, it may also be appropriate to examine Value at Risk measures to limit overall portfolio risk in leveraged environments. Another commenter believed the issue of appropriate leverage measurement methods is best addressed by industry participants. And the concept or method chosen should be clearly formulated, expressed and disclosed and uniformly applicable.	unleveraged ones. Furthermore, we note that although the value-at-risk is a quite comprehensive measure, it may not be a straightforward method of calculation and can be somewhat subjective in its elements. However, we welcome any specific feedback regarding appropriate methodologies for determining leverage and the overall risk of a fund. We welcome any feedback from industry participants in this regard.
Other investment restrictions	One Commenter did not believe a restriction limiting alternative funds to investing in other investment funds that are reporting issuers in the same jurisdictions as the alternative fund is reasonable. A commenter encouraged the CSA to permit NI 81-102 conventional mutual funds to invest up to 10% of their net assets in alternative funds. One commenter did not believe there should be restrictions on alternative funds comparing themselves to conventional mutual funds provided the comparisons are relevant, not misleading and that appropriate disclaimers are included. Another commenter felt all investment funds should be placed on a level playing field with respect to such matters as offering, operational and distribution	Under the Proposed Amendments, alternative funds will be permitted to invest in any investment fund subject to NI 81-102 without requiring that an underlying fund be a reporting issuer in the same jurisdiction as the top fund. This is being proposed under the Proposed Amendments. Under the Proposed Amendments, alternative funds will be defined by how their investment strategies are permitted to differ from those of more conventional mutual funds and will be required to highlight these differences in their disclosure documents. The Proposed Amendments contemplate this. For example, we are proposing that non-listed alternative funds file a simplified prospectus and fund facts and

	requirements.	offer point of sale delivery, and we are also proposing that new alternative funds abide by the same seed capital/start-up requirements as more conventional mutual funds.
	A commenter stated it is not practical to try to list every possible investment strategy that may be created or proposed in the future.	We note that currently, an investment fund is required to disclosure its fundamental investment objectives, including the primary strategies under which it will seek to achieve those objectives. The Proposed Amendments will not amend these requirements.
	One commenter submitted that NI 81-104 should permit alternative funds to invest in funds that are reporting issuers in specified foreign jurisdictions, reporting issuers in at least one Canadian jurisdiction or offered under prospectus exemptions in Canada and have equivalent redemption/liquidity requirements as the top fund.	The Proposed Amendments do not codify this approach as it is our preference to continue to consider investment in funds from a foreign jurisdiction or Canadian funds offered under prospectus exemptions matters on a case-by-case basis through exemptive relief. As noted above, we are proposing to simplify the fund of fund restrictions for to allow investment in underlying funds that are subject to NI 81-102, regardless of which jurisdiction an underlying fund may be a reporting issuer.
	Another commenter stated that the Alternative Funds Proposals should be as permissive as possible and they should not expressly permit or prohibit any strategy.	While the Proposed Amendments do contemplate a wider variety of strategies or asset classes that will be available to alternative funds, we do not agree that alternative funds that will be distributed to the public should have no investment restrictions.
	Two commenters believed that if non-redeemable funds are restricted from holding non-insured mortgages, investment funds that are alternative funds should be permitted to hold them.	We have not proposed to change the current restrictions on investment funds investing in mortgages under NI 81-102 under the Proposed Amendments. Please provide any specific feedback in this regard.

	A commenter expressed the belief that alternative funds should be exempted from paragraph 2.3(i) of NI 81-102 to permit them 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.	We do not agree and have not proposed any changes to these restrictions under the Proposed Amendments. We further take the view that this type of activity is not consistent with the notion of investment funds being passive investment vehicles.
	One commenter believed alternative funds should be permitted to invest up to 20% of their net asset value in illiquid assets.	We have not proposed to increase the illiquid asset limits for alternative funds as we believe the current limits for commodity pools are appropriate for alternative funds. We welcome any specific comments in this regard.
	One commenter felt that it is not in the best interest of investors in alternative funds to only permit "top" alternative funds to invest in underlying mutual funds that in turn hold no more than 10% of their net asset value in securities of other mutual funds. Such a restriction would prevent alternative funds from utilizing many types of efficient and effective multi-tier investment structures. Investors in alternative funds should have access to such multi-tier alternative fund structures, which can deliver the benefits of (1) greater portfolio diversification at a reduced cost relative to that which could otherwise be achieved were the top fund required to invest directly in securities held by the underlying funds; (2) more favourable pricing and transaction costs on portfolio trades, increased access to investments and better economies of scale that can	We do not agree and have not proposed any changes to the current restrictions on multi-tier fund of fund investment structures. These restrictions were originally put in place to reflect CSA concerns regarding, among other things, complexity, transparency, and duplication of fees or hidden fees. These restrictions have been modified from time to time, usually on a case-by-case basis through exemptive relief to reflect multi-tier structures which in the CSA's view do not raise similar concerns. To the extent that there may be specific structures in which the efficiencies may outweigh the regulatory concerns, we remain of the view that these are best addressed through the exemptive relief process.

	be achieved when the top fund invests through underlying funds; and (3) overall reduced portfolio complexity and increased administrative ease, which results in efficiencies that can be passed on to investors in the top funds. The above-noted advantages outweigh regulatory concerns regarding the potential complexity of the structure and duplication of fees, which can be appropriately addressed through disclosure and restrictions on duplication of fund fees and costs. A commenter supported the CSA's proposal to maintain the exemptions in 2.3(d)-(g) and (h), 2.8 and 2.11 of NI 81-104 for alternative funds. One commenter felt NI 81-104 should not impose any further restrictions. Should provide for ample flexibility for strategies that are not provided for in NI 81-102.	Thank you for the comment. We are proposing to maintain these exemptions for alternative funds. The Proposed Amendments aim at providing a reasonable balance between encouraging innovative strategies and investors protection.
On-going investment by sponsors	Two commenters did not believe there is a reasonable basis for creating a different seed capital requirement for alternative funds. Two commenters thought sponsors of an alternative fund should be able to withdraw their seed capital once the fund reaches a certain size.	We agree. Under the Proposed Amendments, the seed capital requirements for alternatives will be the same as for other mutual funds. We agree. Under the Proposed Amendments, alternative funds will be permitted to start withdrawing seed capital once the fund has raised $500,000 in capital from "outside" sources, which is consistent with the requirements for conventional mutual funds.

	One commenter felt sponsors should not be required to maintain an investment in their fund. However, where a sponsor does so, the seed capital should be included in the sponsor's working capital calculation. One commenter did not think seed capital requirements should apply to non-redeemable investment funds.	Please see above. We are proposing to amend the seed capital requirements for alternative funds to align with those of other mutual funds. We have not proposed to change the seed capital requirements applicable to non-redeemable investment funds under the Proposed Amendments.
Proficiency standards for representatives dealing in Alternative Funds	Several commenters did not feel additional proficiency requirements are necessary for individuals dealing in alternative funds. Additional proficiency requirements would only limit the distribution channels available to alternative funds. Two commenters thought that IIROC registered representatives should not require additional proficiency requirements to sell alternative funds but that proficiency standards for mutual fund restricted representatives should be maintained. [8] One commenter stated that there are no existing courses or proficiency requirements for dealing representatives that would add value to the offering of alternatives funds. [9] One commenter encouraged the CSA to reconsider the existing proficiency requirements in NI 81-104 with the goal of determining whether these are appropriate or necessary. One commenter thought it was necessary that individual representatives that sell alternative funds have a fiduciary duty to act in the best interests of their	Under the Proposed Amendments, we are proposing to remove the proficiency requirements currently applicable to mutual fund restricted individuals that trade in securities of a commodity pool (the Proficiency Requirements) under NI 81-104 for alternative funds. This recognizes that a fund operational rule is not the appropriate place for what is essentially a "know your product" provision and that some of provisions may be out of date, having not been updated since its initial implementation. We are of the view that these requirements would be best addressed directly through the registrant regulatory regime including through SRO's such as the Mutual Fund Dealers Association (MFDA), which are best placed to determine the appropriate proficiency standards for mutual fund dealer representatives. To that end we will be working with the MFDA to come to the best solution on this issue. We have not proposed any changes to the proficiency requirements for IIROC registrants. We welcome any specific feedback on the Proficiency Requirements in light of the Proposed Amendments.

	clients. Another commenter supported improved proficiency requirements for all registrants who sell investment funds, and, in particular, increased proficiency requirements for registrants selling alternative funds. A commenter felt the current mutual fund course does not sufficiently address the topic of alternative funds and that additional alternative funds content should be added to the current course or a separate alternative funds course should be created. One commenter stated that the proposal to impose additional proficiency requirements on individual dealing representatives who sell securities of alternative funds is fundamental to the success of the Alternative Funds Proposals. The commenter believes that many problems that have occurred with alternative investments could have been avoided where individual dealer representatives properly understood the risks of their products and effectively discharged their suitability obligations. The commenter suggested that the CSA should consider Chartered Financial Analyst, Chartered Investment Manager or Chartered Alternative Investment Analyst designations as proficiency standards for representatives dealing in alternative funds. One commenter suggested the CSA consider the creation of individual registration categories for alternative fund dealing representative and associate alternative fund dealing representative.	

	A commenter stated, with respect to non-redeemable investment funds in particular, the creation of additional proficiency requirements for the sale of alternative fund securities would represent a fundamental and potentially adverse change to the ongoing business and affairs of existing non-redeemable investment funds as well as the manufacture and distribution of non-redeemable investment funds in Canada.	

Naming convention for Alternative Funds	Most commenters who provided comments regarding the imposition of a naming convention for alternative funds objected to either the concept of a naming convention or to the proposed use of the term alternative fund.	Please note that we are not proposing a naming convention for alternative funds under the Proposed Amendments.
	Many commenters objected to the proposed use of the words alternative fund as part of the naming convention. These commenters felt such a term could result in alternative funds being labeled as high risk or volatile.	Please see above.
	Many commenters felt the term alternative fund would not necessarily identify for investors the nature of alternative funds or level of risk and complexity that is associated with these funds.	Please see above. We agree, which is why the Proposed Amendments include specific disclosure requirements for alternative fund prospectuses.
	Several commenters believed that improved disclosure was a better approach than a naming convention. These commenters believed it would be more useful for each fund to provide investors with meaningful and prominent disclosure of the fund's key investment objectives, strategies and risks in its disclosure documents, and for non-conventional 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.	We agree. Please see above. Among the provisions applicable to alternative fund disclosure in the Proposed Amendments will be a requirement for an alternative fund to disclosure how its investment strategies differ from what is permitted by a conventional mutual fund.
	Several commenters specifically stated that drawing a clear line between funds subject to either NI 81-102 or NI 81-104 may mislead investors into believing that all funds under one framework are the same and draw attention away from the wide variance among funds	We note that this is the case today as between mutual funds and commodity pools, but we welcome specific feedback on the Proposed Amendments on this issue or concern.

	within each framework.	
	One commenter felt the imposition of a naming convention would be a highly effective tool and agreed with the use of the words alternative fund.	While we have not proposed a naming convention that would mandate the use of the world “alternative fund” in a fund’s name, the term will be still be used for descriptive purposes in distinguishing an alternative fund from a conventional mutual fund.
	One commenter believed better labeling in the name of the investment fund of the heightened risk and complexity along with more robust regulation and enforcement of misleading advertising, coupled with a best interest standard, would go a long way to helping to protect investors. The commenter suggested that such funds be called "Risk-Magnified Funds", "Higher-Risk Funds" or some other term that sets out clearly that such funds carry increased risks, as compared to conventional non-redeemable investment funds and mutual funds.	As noted above, we have not proposed to institute a naming convention for alternative funds, though the term will be used for descriptive purposes. While we do not agree that alternative funds will in all cases be inherently riskier than all conventional funds, we welcome any comments regarding whether we should consider a different term to describe these funds than “alternative funds”.
	A commenter suggested investment products should have risk labeling and that the CSA should ban the sale of certain classes of types of product to retail investors.	We note that the regulatory framework for investment funds requires disclosure of applicable risk factors as well as requiring risk ratings for investment funds. As well, the applicable investment restrictions for investment funds that are distributed to the public necessarily restrict the types of products that can be sold to retail investors.
	One commenter stated that requiring existing funds to change their names to comply with a naming convention requirement would create unnecessary cost and confusion to investors.	Please see above. We have not proposed a naming convention for alternative funds.

	A couple commenters believed it would be more helpful to differentiate products based on their structure and that a descriptor based on the type of securities a fund may invest in or its investment strategies could be interpreted in various ways or be too restrictive to describe all possibilities.	NI 81-102 does differentiate funds based on their structure in some aspects (such as whether they are listed or not, or whether or not they are redeemable on a regular basis). We don't believe the Proposed Amendments will necessarily change this.
	One commenter felt that to make a naming convention work, clear definitions of alternative and conventional funds would be necessary.	Please see above. We have not proposed a naming convention, though the term "alternative fund" is being defined in NI 81-102 as part of the Proposed Amendments.
	A couple of commenters believed the term alternative fund is too generic or simplistic to include in a fund name.	Please see above.
	One commenter thought conventional mutual funds should adopt the more fulsome disclosure requirements of the long form prospectus and mutual funds should not be able to bundle multiple funds into a single prospectus.	We do not agree that mutual funds should adopt the long form prospectus. The simplified prospectus and fund facts document were designed to better assist investors in understanding the product. Furthermore, as mutual funds are required to distribute the fund facts document in lieu of a simplified prospectus, we do not see any reason to prohibit the bundling of multiple funds into a single prospectus, which is administratively more efficient.

Monthly website disclosure	One commenter believed there should be no distinction in disclosure requirements for conventional and alternative funds. However the commenter supported the introduction of a requirement that all publicly offered investment funds disclose additional variables to understand the risk and performance of a fund, including the standard deviation of a fund.	We are not proposing specific website disclosure for alternative funds under the Proposed Amendments. However, we will be mandating certain disclosure in a fund's financial statements regarding its experience with leverage. In addition, the fund facts document, which we propose to mandate for alternative funds, discloses adapted information in order to help investors understand a fund's risk and performance.
	A couple of commenters did not believe publishing maximum and average daily leverage would provide meaningful information to investors, as leverage may not be as significant an indicator of risk as other factors. These commenters felt the proposed disclosure requirements are limited and may be taken out of context.	Please see the response above. We note that the total leverage limit is not technically a risk indicator.
	One commenter felt these seemed like reasonable proposals and would not be too onerous on the part of the manager to implement.	Thank you for your comment.
	Another commenter agrees with the proposed disclosure requirements and thinks other risk metrics on a quarterly basis may be useful to investors.	Please provide any additional feedback on what risk metrics could be relevant for investors.
	One commenter stated that disclosure of monthly performance data would be more meaningful and that the proposed disclosure may be misleading. In particular, the disclosure of maximum drawdown is in the absence of further information will not useful. The commenter suggested the CSA revisit general instruction 11 to Form 41-101F2 to allow for performance data over shorter periods of time.	We are not proposing to review performance data disclosure.

Transition to Alternative Funds Framework	Many Commenters believed existing funds should be grandfathered and not made to transition to the alternative funds framework. One commenter felt existing funds that are not offering securities to the public should be grandfathered. One commenter stated that if existing funds were made to comply with a new regulatory regime there would be considerable costs associated with changes to funds and their investment strategies. A commenter felt existing funds that are required to transition to the alternative funds framework should be permitted to provide written notice of their intention to transition into the alternative funds regime.	We are proposing a 6 month transition period from the coming into force date for existing funds to transition to the new requirements for alternative funds to the extent that they are impacted by them. However, we will expect any new funds filing a prospectus after the date the Proposed Amendments come into force to comply with those requirements from the first day of operations. We welcome any feedback on whether or not this is an appropriate transition period for existing funds.
Other comments	One commenter stated that alternative funds should be permitted to utilize the NI 81-101 simplified prospectus and fund facts disclosure regime. Another commenter believed the CSA should move ahead with point of sale disclosure for all investment products including alternative funds. One commenter did not believe that an alternative fund should be required to disclose in its prospectus how its investment strategies differ from a conventional fund. Such disclosure is not relevant and potentially misleading. This emphasizes potential risk without allowing potential benefits to be disclosed.	We are proposing that alternative funds that are not listed on an exchange use the simplified prospectus and fund facts under the Proposed Amendments. We are proposing that alternative funds that are not listed on an exchange be subject to the point of sale requirements under NI 81-101. We do not agree as it is these differences that will distinguish an alternative fund from a conventional mutual fund. Therefore we believe this disclosure is important and relevant.

Part III - Comments on proposed interrelated investment restrictions		
Issue	**Comments**	**Responses**
Borrowing (s. 2.6(a) to (c))	CSA to permit non-redeemable investments funds to borrow from lenders outside of Canada. A couple of commenters thought limiting non-redeemable investment funds to borrowing from Canadian financial institutions would significantly limit the sources of financing from non-redeemable investment funds. These commenters felt that non-redeemable investment funds may prefer to borrow from financial institutions that are not Canadian financial institutions because of potential for preferential rates, better terms, or a pre-existing relationship with the lender. A couple of commenters felt it would be appropriate to borrow from a foreign bank or other institution where a fund has an objective to benefit from investing in foreign markets which may be denominated in foreign currencies and desires leverage denominated in the same currencies to hedge currency exposure. Many commenters did not believe that restricting the use of leverage by non-redeemable investment funds is appropriate or necessary to ensure that investors are protected. These commenters encouraged the CSA to reconsider the proposed restriction.	Please see our responses above relating to borrowing by an alternative fund. Please note that we are also seeking feedback regarding any additional specific differences between alternative funds and non-redeemable investment funds that we should consider in respect of the proposed borrowing provisions.

	A number of commenters believed enhanced disclosure would be a better solution than a restriction on borrowing. A number of commenters felt the current borrowing practices of non-redeemable investment funds may not be the most appropriate basis on which to set a borrowing limit. Although there are currently a number of non-redeemable investment funds that would fit within the CSA's proposed restriction on borrowing, the restriction on borrowing may cause some funds to move to the alternative funds regime, which may not be the intention of the CSA. One commenter saw no evidence justifying a conclusion that additional monitoring and controls exist or otherwise it would be in the best interests of investors to be exposed only to Canadian financial institutions. One commenter suggested limiting the list of lenders to Canadian and foreign regulated banks, regulated insurance companies and regulated investment dealers and their wholly-owned subsidiaries. Three commenters expressed concern a requirement to borrow from a Schedule I or II bank would restrict a fund from issuing debt securities. The ability for a fund to offer high yield debt securities would meet this investor demand, while providing existing equity holders with a longer term financing. In the current low interest rate environment, funds may be in the position to secure long term financing at historically low rates.	

	One commenter thought that due to their nature, only a low level of liquidity is required on an ongoing basis for non-redeemable investment funds to cover recurring expenses. One commenter expressed concern that limiting borrowing to Canadian financial institutions would reduce competition and possibly increase borrowing costs for non-redeemable investment funds. Two commenters raised the issue that any restriction to limit borrowing to Canadian financial institutions may be in contravention of international trade agreements to which Canada is a party. One commenter identified leverage as being necessary for non-redeemable investment funds to enter into transactions intended to hedge risk. One commenter felt limiting leverage to cash borrowings would limit a fund's ability to meet its objectives. Some non-redeemable investment funds employ the use of derivatives or short selling as a normal part of their portfolio. These funds, if no longer permitted to enter into these positions, may find it difficult or impossible to achieve their objectives and provide investors with returns similar to those provided in the past. In certain market conditions the ability to short-sell may be the fund's best opportunity to generate positive market returns. The ability to enter into these positions is a point of differentiation between non-redeemable investment funds and mutual funds, which investors expect. The commenter does not	

	consider it appropriate to classify funds with these positions as alternative funds under NI 81-104 unless there are a set of separate rules for non-redeemable investment funds.	

Part IV – List of commenters

Commenters

- AGF Investments Inc.
- Alternative Investment Management Association (AIMA)
- Arrow Capital Management Inc.
- Artemis Investment Management Limited
- Aston Hill Capital Markets Inc.
- Blackheath Fund Management Inc.
- BlackRock Asset Management Canada Limited
- Blake, Cassels & Graydon LLP
- Borden Ladner Gervais LLP
- Brompton Funds Limited
- Canadian Advocacy Council for Canadian CFA Institute Societies, The
- Canadian Foundation for Advancement of Investor Rights (FAIR)
- Canadian Securities Institute, The (CSI)
- Canadian Securities Lending Association (CASLA)
- Canoe Financial LP
- CI Investments Inc.
- Cymbria Corp.
- Faircourt Asset Management Inc.
- Fasken Martineau DuMoulin LLP
- Fidelity Investments Canada ULC

- First Asset Investment Management Inc.
- Front Street Capital
- GD-1 Management Inc. and Global Digit II Management Inc.
- Harvest Portfolios Group Inc.
- IFSE Institute, The
- Investment Funds Institute of Canada, The (IFIC)
- Investment Industry Association of Canada, The (IIAC)
- Man Investments Canada Corp.
- Mark Brown
- McCarthy Tétrault LLP
- McMillan LLP
- Middlefield Group
- Morgan Meighen & Associates Limited
- Osler, Hoskin & Harcourt LLP
- Periscope Capital Inc.
- Private Mortgage Lenders Forum
- Propel Capital Corporation
- Quadravest Capital Management Inc.
- RBC Capital Markets
- RBC Global Asset Management Inc.
- ROI Capital
- Stikeman Elliott LLP
- Stikeman Elliott LLP (on behalf of 42 organizations)
- Stikeman Elliott LLP (on behalf of BMO Capital Markets, CIBC, National Bank Financial, RBC Capital Markets, Scotiabank and TD Securities)
- Strathbridge Asset Management Inc.
- TMX Group Limited
- Trez Capital Fund Management Limited Partnership
- W.A. Robinson Asset Management Ltd.
- Wildeboer Dellelce LLP

Annex C-1

PROPOSED REPEAL OF
NATIONAL INSTRUMENT 81-104 *COMMODITY POOLS*

1. National Instrument 81-104 Commodity Pools is repealed.

2. This Instrument comes into force on •.

Annex C-2

PROPOSED WITHDRAWAL OF
COMPANION POLICY 81-104CP TO
NATIONAL INSTRUMENT 81-104 *COMMODITY POOLS*

1. ***Companion Policy 81-104CP to National Instrument 81-104 Commodity Pools is withdrawn.***

2. This document becomes effective on •.

Annex D-1

PROPOSED AMENDMENTS TO
NATIONAL INSTRUMENT 81-102 *INVESTMENT FUNDS*

1. National Instrument 81-102 Investment Funds is amended by this Instrument.

2. Section 1.1 is amended

(a) by repealing the definition of "acceptable clearing corporation",

(b) in the definition of "clearing corporation" by replacing "options or standardized futures***" with "***specified derivatives***",***

(c) by repealing the definition of "fixed portfolio ETF",

(d) in the definition of "illiquid asset" ***by replacing "***mutual fund***" with "***investment fund***" in paragraph (a) and by replacing "***a mutual fund, the resale of which is prohibited by a representation, undertaking or agreement by the mutual fund or by the predecessor in title of the mutual fund***" with "***an investment fund***" in paragraph (b);***

(e) by repealing the definition of "Joint Regulatory Financial Questionnaire and Report",

(f) by repealing the definition of "permitted gold certificate",

(g) in the definition of "physical commodity" by adding "electricity, water,***" before "***precious stone***",***

(h) in the definition of "public quotation" by replacing "mutual fund***" with "***investment fund***",***

(i) in the definition of "restricted security" by replacing "mutual fund***" with "***investment fund***" and by replacing "***mutual fund's***" with "***investment fund's***", and***

(j) by adding the following definitions:

"alternative fund" means a mutual fund that has adopted fundamental investment objectives that permit it to invest in asset classes or adopt investment strategies that are otherwise prohibited but for prescribed exemptions from Part 2 of this Instrument;**,**

"cleared specified derivative" means a specified derivative that is cleared through a clearing corporation that is any of the following:

(a) registered with the Securities and Exchange Commission;

(b) registered with the US Commodity Futures Trading Commission;

(c) authorized by the European Securities and Markets Authority; or

(d) a regulated clearing agency;**,**

"fixed portfolio investment fund" means an exchange traded mutual fund not in continuous distribution or a non-redeemable investment fund that

(a) has fundamental investment objectives which include holding and maintaining a fixed portfolio of publicly traded equity securities of one or more issuers the names of which are disclosed in its prospectus, and

(b) trades the securities referred to in paragraph (a) only in the circumstances disclosed in its prospectus;**,**

"non-redeemable investment fund" has the same meaning ascribed to that term in National Instrument 81-106 *Investment Fund Continuous Disclosure*;**,**

"permitted precious metals" means gold, silver, platinum and palladium;**,**

"permitted precious metal certificate" means a certificate representing a permitted precious metal if the permitted precious metal is

(a) available for delivery in Canada, free of charge, to or to the order of the holder of the certificate,

(b) in the case of a certificate representing gold, of a minimum fineness of 995 parts per 1000,

(c) in the case of a certificate representing a permitted precious metal other than gold, of a minimum fineness of 999 parts per 1000,

(d) held in Canada,

(e) in the form of either bars or wafers, and

(f) if not purchased from a bank listed in Schedule, I, II or III of the *Bank Act* (Canada), fully insured against loss and bankruptcy by an insurance company licensed under the laws of Canada or a jurisdiction;**,**

"precious metals fund" means a mutual fund, other than an alternative fund, that has adopted a fundamental investment objective to invest primarily in one or more permitted precious metals;***, and***

"regulated clearing agency" has the meaning ascribed to that term in National Instrument 94-101 *Mandatory Central Counterparty Clearing of Derivatives*;**.**

3. Subsection 1.2(3) is amended in paragraph (a) by replacing "sections 2.12 to 2.17;***" with "***section 2.6.1 and sections 2.7 to 2.17;***".***

4. Section 2.1 is amended

(a) in subsection (1) by adding "other than an alternative fund***" after "***mutual fund***", by replacing "***index participation units***" with "***an index participation unit***", by replacing "***percent***" with "***%***"and by adding "***one***" after "***any***",***

(b) by adding the following subsection:

(1.1) An alternative fund or a non-redeemable investment fund must not purchase a security of an issuer, enter into a specified derivatives transaction or purchase an index participation unit if, immediately after the transaction, more than 20% of its net asset value would be invested in securities of any one issuer.***,***

(c) in subsection (2) by replacing "Subsection (1) does***" with "***Subsections (1) and (1.1) do***", by replacing "***a mutual fund***" with "***an investment fund***" wherever it occurs, and by replacing "***fixed portfolio ETF***" with "***fixed portfolio investment fund***",***

(d) in subsection (3) by replacing "a mutual fund's***" with "***an investment fund's***" and by replacing "***the mutual fund***" with "***the investment fund***" wherever it occurs, and***

(e) in subsection (4) by replacing "mutual fund***" with "***investment fund***" and by replacing "***percent***" with "***%***".***

5. Section 2.3 is amended

(a) in paragraph (1)(d) by replacing "gold certificate***" with "***precious metals certificate***" wherever it occurs,***

(b) by replacing paragraph 1(e) with the following:

(e) purchase permitted precious metals, a permitted precious metal certificate or a specified derivative the underlying interest of which is a physical commodity if, immediately after the purchase, more than 10% of the mutual fund's net asset value would be made up of permitted precious metals, permitted precious metal certificates and specified derivatives the underlying interest of which is a physical commodity;***,***

(c) in paragraph 1(g) by adding "or***" immediately after ";",***

(d) by repealing paragraph 1(h),

(e) by adding the following subsections:

(1.1) Paragraphs 1(d), (e), (f) and (g) do not apply to an alternative fund.

(1.2) The restriction in paragraph 1(e) does not apply to a precious metals fund with respect to purchasing permitted precious metals, a permitted precious metal certificate or a specified derivative the underlying interest of which is one or more permitted precious metals***., and***

(f) by adding the following subsections:

(3) In determining an investment fund's compliance with the restrictions contained in this section, for each long position in a specified derivative that is held by the investment fund for purposes other than hedging and for each index participation unit or underlying investment fund held by the investment fund, the investment fund must consider that it holds directly the underlying interest of that specified derivative or its proportionate share of the securities held by the issuer of the index participation unit or underlying investment fund, as applicable.

(4) Despite subsection (3), in the determination referred to in subsection (3) the investment fund must not include a security or instrument that is a component of, but that represents less than 10% of

(a) a stock or bond index that is the underlying interest of a specified derivative, or

(b) the securities held by the issuer of an index participation unit**.**.

6. Section 2.4 is amended

(a) by replacing "percent***" with "***%***" wherever it occurs, and***

(b) by adding the following subsections:

(4) A non-redeemable investment fund must not purchase an illiquid asset if, immediately after the purchase, more than 20% of its net asset value would be made up of illiquid assets.

(5) A non-redeemable investment fund must not have invested, for a period of 90 days or more, more than 25% of its net asset value in illiquid assets.

(6) If more than 25% of the net asset value of a non-redeemable investment fund is made up of illiquid assets, the non-redeemable fund must, as quickly as commercially reasonable, take all necessary steps to reduce the percentage of its net asset value made up of illiquid assets to 25% or less.

7. Subsection 2.5(2) is amended

(a) by replacing paragraph (a) with the following:

(a) if the investment fund is a mutual fund other than an alternative fund, either of the following apply:

(i) the other investment fund is a mutual fund, other than an alternative fund, that is subject to this Instrument;

(ii) the other investment fund is an alternative fund or a non-redeemable investment fund that is subject to this Instrument, provided that the mutual fund must not purchase securities of the alternative fund or non-redeemable investment fund if, immediately after the purchase, more than 10% of its net asset value would be made up of securities of alternative funds and non-redeemable investment funds;**,**

(b) in paragraph (a.1) by adding "an alternative fund or***" before "***a non-redeemable investment fund***" wherever it occurs,***

(c) by replacing paragraph (c) with the following:

(c) the other investment fund is a reporting issuer in a jurisdiction**,** ***and***

(d) by repealing paragraph (c.1).

8. Subsection 2.5(3) is amended by replacing ",(c) and (c.1)***" with "***and (c)***".***

9. Section 2.6 is amended

(a) by renumbering it as subsection 2.6(1),

(b) in paragraph (a) by deleting "in the case of a mutual fund,***",***

(c) in subparagraph (a)(i) replacing "mutual fund***" with "***investment fund***" wherever it occurs, and by replacing "***five percent***" with "***5%***",***

(d) in subparagraph (a)(ii) and subparagraph (a)(iii) by replacing "mutual fund***" with "***investment fund***" wherever it occurs,***

(e) in subparagraph (a)(iv) by adding "or a non-redeemable investment fund***" after "***continuous distribution***",***

(f) in paragraphs (b) and (c) by deleting "in the case of a mutual fund,***", and***

(g) by adding the following subsection:

(2) An alternative fund or a non-redeemable investment fund may borrow cash in excess of the limits set out in subsection (1) provided that each of the following applies:

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

(b) if the lender is an affiliate of the investment fund manager of the alternative fund or non-redeemable investment fund, the independent review committee must approve the applicable borrowing agreement under subsection 5.2(1) of NI 81-107;

(c) the borrowing agreement entered into is in accordance with normal industry practice and on standard commercial terms for the type of transaction;

(d) the total value of cash borrowed must not exceed 50% of the alternative fund or non-redeemable investment fund's net asset value**..**

10. Paragraph 2.6.1(1) is amended

(a) by replacing "A mutual fund***" with "***An investment fund***",***

(b) in subparagraph (b)(i) by replacing "mutual fund***" with "***investment fund***", and***

(c) by replacing paragraph (c) with the following:

(c) at the time the investment fund sells the security short,

(i) the investment fund has borrowed or arranged to borrow from a borrowing agent the security that is to be sold under the short sale,

(ii) if the investment fund is a mutual fund other than an alternative fund, the aggregate market value of all securities of the issuer of the securities sold short by the mutual fund does not exceed 5% of the net asset value of the mutual fund,

(iii)if the investment fund is a mutual fund other than an alternative fund, the aggregate market value of all securities sold short by the mutual fund does not exceed 20% of the net asset value of the mutual fund,

(iv) if the investment fund is an alternative fund or a non-redeemable investment fund, the aggregate market value of all securities of the issuer of the securities sold short by the investment fund does not exceed 10% of the net asset value of the investment fund; and

(v) if the investment fund is an alternative fund or a non-redeemable investment fund, the aggregate market value of all securities sold short by the investment fund does not exceed 50% of the net asset value of the investment fund**..**

11. Subsection 2.6.1(2) is amended by adding "other than an alternative fund***" before "***that sells securities short***".***

12. Subsection 2.6.1(3) is amended by adding "other than an alternative fund***" before "***must not use the cash***".***

13. The Instrument is amended by adding the following section:

2.6.2 – Total Borrowing and Short Selling

(1) Despite sections 2.6 and 2.6.1, an investment fund must not borrow cash or sell securities short, if immediately after entering into a cash borrowing or short selling transaction, the aggregate value of cash borrowed combined with the aggregate market value of all securities sold short by the investment fund would exceed 50% of the investment fund's net asset value.

(2) Despite sections 2.6 and 2.6.1, if the aggregate value of cash borrowed combined with the aggregate market value of all securities sold short by the investment fund exceeds 50% of the investment fund's net asset value, the investment fund must, as quickly as is commercially reasonable, take all necessary steps to reduce the aggregate value of cash borrowed combined with the aggregate market value of securities sold short to 50% or less of the investment fund's net asset value**..**

14. Section 2.7 is amended

(a) in subsection (1) by replacing "A mutual fund***" with "***An investment fund***", by replacing "***.***" with "***;***" in paragraph (c) and by adding the following paragraph:***

(d) the option, debt-like security, swap or contract is a cleared specified derivative**.,**

(b) in subsection (2) by replacing "a mutual fund***" with "***an investment fund***" and "***the mutual fund***" with "***the investment fund***",***

(c) in subsection (3) by replacing "a mutual fund***" with "***an investment fund***",***

(d) in subsection (4) by replacing "a mutual fund***" with "***an investment fund***", by adding "***other than for positions in cleared specified derivatives,***", after "***specified derivatives positions***", by deleting "*** other than an acceptable clearing corporation or a clearing corporation that clears and settles transactions made on a futures exchange listed in Appendix A,***", by replacing "***percent***" with "***%***"and by replacing "***the mutual fund***" with "***the investment fund***",***

(e) in subsection (5) by replacing "a mutual fund***" with "***an investment fund***" and by replacing "***mutual fund***" with "***investment fund***" wherever it occurs, and***

(f) by adding the following subsection:

(6) Subsections (1), (2) and (3) do not apply to an alternative fund or a non-redeemable investment fund**..**

15. Section 2.8 is amended by adding the following subsection:

(0.1) This section does not apply to an alternative fund**..**

16. The Instrument is amended by adding the following section:

2.9.1 Leverage

(1) An investment fund's aggregate gross exposure must not exceed 3 times the investment fund's net asset value.

(2) For the purposes of subsection (1), an investment fund's aggregate gross exposure must be calculated as the sum of the following, divided by the investment fund's net asset value:

(a) the aggregate value of the investment fund's indebtedness under any borrowing agreements entered into pursuant to section 2.6;

(b) the aggregate market value of all securities sold short by the investment fund pursuant to section 2.6.1;

(c) the aggregate notional amount of the investment's fund's specified derivatives positions.

(3) In determining an investment fund's compliance with the restriction contained in this section, the investment fund must also include in its calculation its proportionate shares of securities of any underlying investment funds for which a similar calculation is required.

(4) An investment fund must determine its compliance with the restriction contained in this section as of the close of business of each day on which the investment fund calculates a net asset value.

(5) If the investment fund's aggregate gross exposure as determined in subsection (2) exceeds 3 times the investment fund's net asset value, the investment fund must, as quickly as is commercially reasonable, take all necessary steps to reduce the aggregate gross exposure to 3 times the investment fund's net asset value or less.

17. Section 2.11 is amended by adding the following subsection:

(0.1) This section does not apply to an alternative fund**..**

18. Subsection 6.8(1) is amended by adding "Borrowing,***" before "***Derivatives***" in the heading, by replacing "***clearing corporation options, options on futures or standardized futures***" with "***cleared specified derivatives***" and by replacing "***percent***" with "***%***".***

19. Subsection 6.8(2) is amended

(a) by replacing "clearing corporation options, options or futures or standardized futures***" with "***cleared specified derivatives***",***

(b) in paragraph (a) by deleting "in the case of standardized futures and options on futures,***" and by deleting "***, in the case of clearing corporation options***", and***

(c) in paragraph (c) by replacing "percent***" with "***%***".***

20. Section 6.8 is amended by adding the following subsection:

(3.1) An investment fund may deposit with its lender, portfolio assets over which it has granted a security interest in connection with a borrowing agreement entered into pursuant to section 2.6**..**

21. Subsection 6.8(4) is amended by replacing "or (3)***" with "***,(3) or (3.1)***".***

22. Subsection 6.8(5) is amended by adding "borrowing,***" before "***securities lending***".***

23. Section 7.1 is amended

(a) by renumbering it as subsection 7.1(1),

(b) by adding "other than an alternative fund***" after "***A mutual fund***", and***

(c) by adding the following subsection:

(2) An alternative fund must not pay, or enter into arrangements that would require it to pay, and securities of an alternative fund must not be sold on the basis that an investor would be required to pay, a fee that is determined by the performance of the alternative fund unless

(a) the payment of the fee is based on the cumulative total return of the alternative fund for the period that began immediately after the last period for which the performance fee was paid, and

(b) the method of calculating the fee is described in the alternative fund's prospectus**..**

24. Section 9.1.1 is amended in paragraph (b) by adding "short***" before "***position***".***

25. Section 10.1 is amended by adding the following subsection immediately after subsection (2):

(2.1) If disclosed in its prospectus, an alternative fund may include, as part of the requirements established in subsection (2), a provision that securityholders of the alternative fund will not have the right to redeem their securities for a period up to 6 months after the date on which the receipt is issued for the initial prospectus of the alternative fund**..**

26. Section 10.3 is amended by adding the following subsection:

(5) Despite subsection (1) an alternative fund may implement a policy providing 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 first or 2nd business day after the date of receipt by the alternative fund of the redemption order**..**

27. Subsection 10.4(1.1) is amended by adding "an alternative fund or***" after "***Despite subsection (1),***".***

28. Subsection 15.13(2) is amended by replacing "a commodity pool***" with "***an alternative fund***" wherever it occurs and by replacing "***National Instrument 81-104 *Commodity Pool*** ***" with "***this Instrument***".***

29. The Instrument is amended by repealing Appendix A – Futures Exchanges for the Purpose of Subsection 2.7(4) – Derivative Counterparty Exposure Limits.

30.(1) Subject to subsections (2) and (3), this Instrument comes into force on •.

(2) If a non-redeemable investment fund or alternative fund has filed a prospectus before •, then this Instrument will not apply to that non-redeemable investment fund or alternative fund until the date that is 6 months from the date referred to in subsection (1).

(3) A mutual fund that is a commodity pool under National Instrument 81-104 *Commodity Pools* and has filed a prospectus before the date of this Instrument will be deemed to be an alternative fund for the purposes of subsection (2).

Annex D-2

BLACKLINE OF
NATIONAL INSTRUMENT 81-102 *INVESTMENT FUNDS*
TO HIGHLIGHT THE PROPOSED AMENDMENTS

TABLE OF CONTENTS

NATIONAL INSTRUMENT 81-102
INVESTMENT FUNDS

PART 1 DEFINITIONS AND APPLICATION

1.1 Definitions - In this Instrument

"acceptable clearing corporation" ~~means a clearing corporation that is an acceptable clearing corporation under the Joint Regulatory Financial Questionnaire and Report~~[Repealed];

"advertisement" means a sales communication that is published or designed for use on or through a public medium;

"alternative fund" means a mutual fund that has adopted fundamental investment objectives that permit it to invest in asset classes or adopt investment strategies that are otherwise prohibited but for prescribed exemptions from Part 2 of this Instrument;

"asset allocation service" means an administrative service under which the investment of a person or company is allocated, in whole or in part, among mutual funds to which this Instrument applies and reallocated among those mutual funds and, if applicable, other assets according to an asset allocation strategy;

"book-based system" means a system for the central handling of securities or equivalent book-based entries under which all securities of a class or series deposited within the system are treated as fungible and may be transferred or pledged by bookkeeping entry without physical delivery;

"borrowing agent" means any of the following:

(a) a custodian or sub-custodian that holds assets in connection with a short sale of securities by an investment fund;

(b) a qualified dealer from whom an investment fund borrows securities in order to sell them short;

"cash cover" means any of the following assets of a mutual fund that are held by the mutual fund, have not been allocated for specific purposes and are available to satisfy all or part of the obligations arising from a position in specified derivatives held by the mutual fund or from a short sale of securities made by the mutual fund:

(a) cash;

(b) cash equivalents;

(c) synthetic cash;

(d) receivables of the mutual fund arising from the disposition of portfolio assets, net of payables arising from the acquisition of portfolio assets;

(e) securities purchased by the mutual fund in a reverse repurchase transaction under section 2.14, to the extent of the cash paid for those securities by the mutual fund;

(f) each evidence of indebtedness that has a remaining term to maturity of 365 days or less and a designated rating;

(g) each floating rate evidence of indebtedness if

(i) the floating interest rate of the indebtedness is reset no later than every 185 days, and

(ii) the principal amount of the indebtedness will continue to have a market value of approximately par at the time of each change in the rate to be paid to the holders of the evidence of indebtedness;

(h) securities issued by a money market fund;

"cash equivalent" means an evidence of indebtedness that has a remaining term to maturity of 365 days or less and that is issued, or fully and unconditionally guaranteed as to principal and interest, by

(a) the government of Canada or the government of a jurisdiction,

(b) the government of the United States of America, the government of one of the states of the United States of America, the government of another sovereign state or a permitted supranational agency, if, in each case, the evidence of indebtedness has a designated rating, or

(c) a Canadian financial institution, or a financial institution that is not incorporated or organized under the laws of Canada or of a jurisdiction if, in either case, evidences of indebtedness of that issuer or guarantor that are rated as short term debt by a designated rating organization or its DRO affiliate have a designated rating;

"cleared specified derivative" means a specified derivative that is cleared through a clearing corporation that is any of the following:

(a) registered with the Securities and Exchange Commission;

(b) registered with the U.S. Commodity Futures Trading Commission;

(c) authorized by the European Securities and Markets Authority; or

(d) a regulated clearing agency;

"clearing corporation" means an organization through which trades in ~~options or standardized futures~~specified derivatives are cleared and settled;

"clearing corporation option" means an option, other than an option on futures, issued by a clearing corporation;

"clone fund" means an investment fund that has adopted a fundamental investment objective to track the performance of another investment fund;

"conventional convertible security" means a security of an issuer that is, according to its terms, convertible into, or exchangeable for, other securities of the issuer, or of an affiliate of the issuer;

"conventional floating rate debt instrument" means an evidence of indebtedness of which the interest obligations are based upon a benchmark commonly used in commercial lending arrangements;

"conventional warrant or right" means a security of an issuer, other than a clearing corporation, that gives the holder the right to purchase securities of the issuer or of an affiliate of the issuer;

"currency cross hedge" means the substitution by an investment fund of a risk to one currency for a risk to another currency, if neither currency is a currency in which the investment fund determines its net asset value per security and the aggregate amount of currency risk to which the investment fund is exposed is not increased by the substitution;

"custodian" means the institution appointed by an investment fund to hold portfolio assets of the investment fund;

"dealer managed investment fund" means an investment fund the portfolio adviser of which is a dealer manager;

"dealer managed mutual fund" [Repealed]

"dealer manager" means

(a) a specified dealer that acts as a portfolio adviser,

(b) a portfolio adviser in which a specified dealer, or a partner, director, officer, salesperson or principal shareholder of a specified dealer, directly or indirectly owns of record or beneficially, or exercises control or direction over, securities carrying more than 10 percent of the total votes attaching to securities of the portfolio adviser, or

(c) a partner, director or officer of a portfolio adviser referred to in paragraph (b);

"debt-like security" means a security purchased by a mutual fund, other than a conventional convertible security or a conventional floating rate debt instrument, that evidences an indebtedness of the issuer if

(a) either

(i) the amount of principal, interest or principal and interest to be paid to the holder is linked in whole or in part by a formula to the appreciation or depreciation in the market price, value or level of one or more underlying interests on a predetermined date or dates, or

(ii) the security provides the holder with a right to convert or exchange the security into or for the underlying interest or to purchase the underlying interest, and

(b) on the date of acquisition by the mutual fund, the percentage of the purchase price attributable to the component of the security that is not linked to an underlying interest is less than 80 percent of the purchase price paid by the mutual fund;

"delta" means the positive or negative number that is a measure of the change in market value of an option relative to changes in the value of the underlying interest of the option;

"designated rating" means, for a security or instrument, a rating issued by a designated rating organization, or its DRO affiliate, that is at or above one of the following rating categories, or that is at or above a category that replaces one of the following rating categories, if

(a) there has been no announcement by the designated rating organization or its DRO affiliate of which the investment fund or its manager is or reasonably should be aware that the rating of the security or instrument to which the designated rating was given may be down-graded to a rating category that would not be a designated rating, and

(b) no designated rating organization or any of its DRO affiliates has rated the security or instrument in a rating category that is not a designated rating:

Designated Rating Organization	**Commercial Paper/ Short Term Debt**	**Long Term Debt**
DBRS Limited	R-1 (low)	A
Fitch, Inc.	F1	A
Moody's Canada Inc.	P-1	A2
Standard & Poor's Ratings Services (Canada)	A-1 (Low)	A

"designated rating organization" means

(a) each of DBRS Limited, Fitch, Inc., Moody's Canada Inc., Standard & Poor's Ratings Services (Canada), including their DRO affiliates; or

(b) any other credit rating organization that has been designated under securities legislation;

"DRO affiliate" has the same meaning as in section 1 of National Instrument 25-101 Designated Rating Organizations;

"equivalent debt" means, in relation to an option, swap, forward contract or debt-like security, an evidence of indebtedness of approximately the same term as, or a longer term than, the

remaining term to maturity of the option, swap, contract or debt-like security and that ranks equally with, or subordinate to, the claim for payment that may arise under the option, swap, contract or debt-like security;

"fixed portfolio ETF" [Repealed]

"fixed portfolio ~~ETF~~investment fund" means an exchange-traded mutual fund not in continuous distribution or a non-redeemable investment fund that

(a) has fundamental investment objectives which include holding and maintaining a fixed portfolio of publicly traded equity securities of one or more issuers the names of which are disclosed in its prospectus, and

(b) trades the securities referred to in paragraph (a) only in the circumstances disclosed in its prospectus;

"floating rate evidence of indebtedness" means an evidence of indebtedness that has a floating rate of interest determined over the term of the obligation by reference to a commonly used benchmark interest rate and that satisfies any of the following:

(a) if the evidence of indebtedness was issued by a person or company other than a government or a permitted supranational agency, it has a designated rating;

(b) the evidence of indebtedness was issued, or is fully and unconditionally guaranteed as to principal and interest, by any of the following:

(i) the government of Canada or the government of a jurisdiction of Canada;

(ii) the government of the United States of America, the government of one of the states of the United States of America, the government of another sovereign state or a permitted supranational agency, if, in each case, the evidence of indebtedness has a designated rating;

"forward contract" means an agreement, not entered into with, or traded on, a stock exchange or futures exchange or cleared by a clearing corporation, to do one or more of the following on terms or at a price established by or determinable by reference to the agreement and at or by a time in the future established by or determinable by reference to the agreement:

1. Make or take delivery of the underlying interest of the agreement.
2. Settle in cash instead of delivery;

"fundamental investment objectives" means the investment objectives of an investment fund that define both the fundamental nature of the investment fund and the fundamental investment features of the investment fund that distinguish it from other investment funds;

"futures exchange" means an association or organization operated to provide the facilities necessary for the trading of standardized futures;

"government security" means an evidence of indebtedness issued, or fully and unconditionally guaranteed as to principal and interest, by any of the government of Canada, the government of a jurisdiction or the government of the United States of America;

"guaranteed mortgage" means a mortgage fully and unconditionally guaranteed, or insured, by the government of Canada, by the government of a jurisdiction or by an agency of any of those governments or by a corporation approved by the Office of the Superintendent of Financial Institutions to offer its services to the public in Canada as an insurer of mortgages;

"hedging" means the entering into of a transaction, or a series of transactions, and the maintaining of the position or positions resulting from the transaction or series of transactions

(a) if

(i) the intended effect of the transaction, or the intended cumulative effect of the series of transactions, is to offset or reduce a specific risk associated with all or a portion of an existing investment or position or group of investments or positions,

(ii) the transaction or series of transactions results in a high degree of negative correlation between changes in the value of the investment or position, or group of investments or positions, being hedged and changes in the value of the instrument or instruments with which the investment or position is hedged, and

(iii) there are reasonable grounds to believe that the transaction or series of transactions no more than offset the effect of price changes in the investment or position, or group of investments or positions, being hedged, or

(b) if the transaction, or series of transactions, is a currency cross hedge;

"IIROC" means the Investment Industry Regulatory Organization of Canada;

"illiquid asset" means

(a) a portfolio asset that cannot be readily disposed of through market facilities on which public quotations in common use are widely available at an amount that at least approximates the amount at which the portfolio asset is valued in calculating the net asset value per security of the ~~mutual~~investment fund, or

(b) a restricted security held by ~~a mutual fund, the resale of which is prohibited by a representation, undertaking or agreement by the mutual fund or by the predecessor in title of the mutual~~an investment fund;

"independent review committee" means the independent review committee of the investment fund established under National Instrument 81-107 *Independent Review Committee for Investment Funds*;

"index mutual fund" means a mutual fund that has adopted fundamental investment objectives that require the mutual fund to

(a) hold the securities that are included in a permitted index or permitted indices of the mutual fund in substantially the same proportion as those securities are reflected in that permitted index or those permitted indices, or

(b) invest in a manner that causes the mutual fund to replicate the performance of that permitted index or those permitted indices;

"index participation unit" means a security traded on a stock exchange in Canada or the United States and issued by an issuer the only purpose of which is to

(a) hold the securities that are included in a specified widely quoted market index in substantially the same proportion as those securities are reflected in that index, or

(b) invest in a manner that causes the issuer to replicate the performance of that index;

"investment fund conflict of interest investment restrictions" means the provisions of securities legislation that are referred to in Appendix D;

"investment fund conflict of interest reporting requirements" means the provisions of securities legislation that are referred to in Appendix E;

"investor fees" means, in connection with the purchase, conversion, holding, transfer or redemption of securities of an investment fund, all fees, charges and expenses that are or may become payable by a securityholder of the investment fund to,

(a) in the case of a mutual fund, a member of the organization of the mutual fund other than a member of the organization acting solely as a participating dealer, and

(b) in the case of a non-redeemable investment fund, the manager of the non-redeemable investment fund;

"Joint Regulatory Financial Questionnaire and Report" ~~means the Joint Regulatory Financial Questionnaire and Report of various Canadian SROs on the date that this Instrument comes into force and every successor to the form that does not materially lessen the criteria for an entity to be recognized as an "acceptable clearing corporation";~~[Repealed]

"long position" means a position held by an investment fund that, for

(a) an option, entitles the investment fund to elect to purchase, sell, receive or deliver the underlying interest or, instead, pay or receive cash,

(b) a standardized future or forward contract, obliges the investment fund to accept delivery of the underlying interest or, instead, pay or receive cash,

(c) a call option on futures, entitles the investment fund to elect to assume a long position in standardized futures,

(d) a put option on futures, entitles the investment fund to elect to assume a short position in standardized futures, and

(e) a swap, obliges the investment fund to accept delivery of the underlying interest or receive cash;

"management expense ratio" means the ratio, expressed as a percentage, of the expenses of an investment fund to its average net asset value, calculated in accordance with Part 15 of National Instrument 81-106 *Investment Fund Continuous Disclosure*;

"manager" means an investment fund manager;

"manager-prescribed number of units" means, in relation to an exchange-traded mutual fund that is in continuous distribution, the number of units determined by the manager from time to time for the purposes of subscription orders, exchanges, redemptions or for other purposes;

"material change**"** has the meaning ascribed to that term in National Instrument 81-106 *Investment Fund Continuous Disclosure*;

"member of the organization" has the meaning ascribed to that term in National Instrument 81-105 Mutual Fund Sales Practices;

"MFDA" means the Mutual Fund Dealers Association of Canada;

"money market fund" means a mutual fund that invests its assets in accordance with section 2.18;

"mortgage" includes a hypothec or security that creates a charge on real property in order to secure a debt;

"mutual fund conflict of interest investment restrictions" [Repealed]

"mutual fund conflict of interest reporting requirements" [Repealed]

"mutual fund rating entity" means an entity

(a) that rates or ranks the performance of mutual funds or asset allocation services through an objective methodology that is

(i) based on quantitative performance measurements,

(ii) applied consistently to all mutual funds or asset allocation services rated or ranked by it, and

(iii) disclosed on the entity's website,

(b) that is not a member of the organization of any mutual fund, and

(c) whose services to assign a rating or ranking to any mutual fund or asset allocation service are not procured by the promoter, manager, portfolio adviser, principal distributor or participating dealer of any mutual fund or asset allocation service, or any of their affiliates;

"net asset value" means the value of the total assets of the investment fund less the value of the total liabilities, other than net assets attributable to securityholders, of the investment fund, as at a specific date, determined in accordance with Part 14 of National Instrument 81-*106 Investment Fund Continuous Disclosure*;

"NI 81-107" means National Instrument 81-107 *Independent Review Committee for Investment Funds*;

"non-redeemable investment fund" has the same meaning ascribed to that term in National Instrument 81-106 *Investment Fund Continuous Disclosure;*

"non-resident sub-adviser" means a person or company providing portfolio management advice

(a) whose principal place of business is outside of Canada,

(b) that advises a portfolio adviser to an investment fund, and

(c) that is not registered under securities legislation in the jurisdiction in which the portfolio adviser that it advises is located;

"option" means an agreement that provides the holder with the right, but not the obligation, to do one or more of the following on terms or at a price established by or determinable by reference to the agreement at or by a time established by the agreement:

1. Receive an amount of cash determinable by reference to a specified quantity of the underlying interest of the option.

2. Purchase a specified quantity of the underlying interest of the option.

3. Sell a specified quantity of the underlying interest of the option;

"option on futures" means an option the underlying interest of which is a standardized future;

"order receipt office" means, for a mutual fund

(a) the principal office of the mutual fund,

(b) the principal office of the principal distributor of the mutual fund, or

(c) a location to which a purchase order or redemption order for securities of the mutual fund is required or permitted by the mutual fund to be delivered by participating dealers or the principal distributor of the mutual fund;

"overall rating or ranking" means a rating or ranking of a mutual fund or asset allocation service that is calculated from standard performance data for one or more performance measurement periods, which includes the longest period for which the mutual fund or asset allocation service is required under securities legislation to calculate standard performance data, other than the period since the inception of the mutual fund;

"participating dealer" means a dealer other than the principal distributor that distributes securities of a mutual fund;

"participating fund" means a mutual fund in which an asset allocation service permits investment;

"performance data" means a rating, ranking, quotation, discussion or analysis regarding an aspect of the investment performance of an investment fund, an asset allocation service, a security, an index or a benchmark;

"permitted gold certificate" ~~means a certificate representing gold if the gold is~~[Repealed]

~~(a) available for delivery in Canada, free of charge, to or to the order of the holder of the certificate,~~

~~(b) of a minimum fineness of 995 parts per 1,000,~~

~~(c) held in Canada,~~

~~(d) in the form of either bars or wafers, and~~

~~(e) if not purchased from a bank listed in Schedule I, II or III of the *Bank Act (Canada)*, fully insured against loss and bankruptcy by an insurance company licensed under the laws of Canada or a jurisdiction;~~

"permitted index" means, in relation to a mutual fund, a market index that is

(a) both

(i) administered by an organization that is not affiliated with any of the mutual fund, its manager, its portfolio adviser or its principal distributor, and

(ii) available to persons or companies other than the mutual fund, or

(b) widely recognized and used;

"permitted precious metals" means gold, silver, platinum and palladium;

"permitted precious metal certificate" means a certificate representing a permitted precious metal if the permitted precious metal is

(a) available for delivery in Canada, free of charge, to or to the order of the holder of the certificate,

(b) in the case of a certificate representing gold, of a minimum fineness of 995 parts per 1000,

(c) in the case of a certificate representing a permitted precious metal other than gold, of a minimum fineness of 999 parts per 1000,

(d) held in Canada,

(e) in the form of either bars or wafers, and

(f) if not purchased from a bank listed in Schedule I, II or III of the *Bank Act (Canada)*, fully insured against loss and bankruptcy by an insurance company licensed under the laws of Canada or a jurisdiction;

"permitted supranational agency" means the African Development Bank, the Asian Development Bank, the Caribbean Development Bank, the European Bank for Reconstruction and Development, the European Investment Bank, the Inter-American Development Bank, the International Bank for Reconstruction and Development and the International Finance Corporation;

"physical commodity", means, in an original or processed state, an agricultural product, forest product, product of the sea, mineral, metal, hydrocarbon fuel product, electricity, water, precious stone or other gem;

"portfolio adviser" means a person or company that provides investment advice or portfolio management services under a contract with the investment fund or with the manager of the investment fund;

"portfolio asset" means an asset of an investment fund;

"precious metals fund" means a mutual fund other than an alternative fund, that has adopted a fundamental investment objective to invest primarily in one or more permitted precious metals;

"pricing date" means, for the sale of a security of a mutual fund, the date on which the net asset value per security of the mutual fund is calculated for the purpose of determining the price at which that security is to be issued;

"principal distributor" means a person or company through whom securities of a mutual fund are distributed under an arrangement with the mutual fund or its manager that provides

(a) an exclusive right to distribute the securities of the mutual fund in a particular area, or

(b) a feature that gives or is intended to give the person or company a material competitive advantage over others in the distribution of the securities of the mutual fund;

"public quotation" includes, for the purposes of calculating the amount of illiquid assets held by ~~a mutual~~an investment fund, any quotation of a price for a fixed income security made through the inter-dealer bond market;

"purchase" means, in connection with an acquisition of a portfolio asset by an investment fund, an acquisition that is the result of a decision made and action taken by the investment fund;

"qualified security" means

(a) an evidence of indebtedness that is issued, or fully and unconditionally guaranteed as to principal and interest, by

(i) the government of Canada or the government of a jurisdiction,

(ii) the government of the United States of America, the government of one of the states of the United States of America, the government of another sovereign state, or a permitted supranational agency, if, in each case, the evidence of indebtedness has a designated rating, or

(iii) a Canadian financial institution or a financial institution that is not incorporated or organized under the laws of Canada or of a jurisdiction if, in either case, evidences of indebtedness of that issuer or guarantor that are rated as short term debt by a designated rating organization or its DRO affiliate have a designated rating, or

(b) commercial paper that has a term to maturity of 365 days or less and a designated rating and that was issued by a person or company other than a government or permitted supranational agency;

"redemption payment date" [Repealed]

"regulated clearing agency" has the meaning ascribed to that term in National Instrument 94-101 *Mandatory Central Counterparty Clearing of Derivatives*;

"report to securityholders" means a report that includes annual financial statements or interim financial reports, or an annual or interim management report of fund performance, and that is delivered to securityholders of an investment fund;

"restricted security" means a security, other than a specified derivative, the resale of which is restricted or limited by a representation, undertaking or agreement by the ~~mutual~~investment fund or by the ~~mutual~~investment fund's predecessor in title, or by law;

"sales communication" means a communication relating to, and by, an investment fund or asset allocation service, its promoter, manager, portfolio adviser, principal distributor, a participating dealer or a person or company providing services to any of them, that

(a) is made

(i) to a securityholder of the investment fund or participant in the asset allocation service, or

(ii) to a person or company that is not a securityholder of the investment fund or participant in the asset allocation service, to induce the purchase of securities of the investment fund or the use of the asset allocation service, and

(b) in the case of an investment fund, is not contained in any of the following documents of the investment fund:

1. A prospectus or preliminary or pro forma prospectus.

2. An annual information form or preliminary or pro forma annual information form.

3. A fund facts document or preliminary or pro forma fund facts document.

4. Financial statements, including the notes to the financial statements and the auditor's report on the financial statements.

5. A trade confirmation.

6. A statement of account.

7. Annual or interim management report of fund performance;

"scholarship plan" has the meaning ascribed to that term in section 1.1 of National Instrument 81-106 *Investment Fund Continuous Disclosure*;

"short position" means a position held by an investment fund that, for

(a) an option, obliges the investment fund, at the election of another, to purchase, sell, receive or deliver the underlying interest, or, instead, pay or receive cash,

(b) a standardized future or forward contract, obliges the investment fund, at the election of another, to deliver the underlying interest or, instead, pay or receive cash,

(c) a call option on futures, obliges the investment fund, at the election of another, to assume a short position in standardized futures, and

(d) a put option on futures, obliges the investment fund, at the election of another, to assume a long position in standardized futures;

"special warrant" means a security that, by its terms or the terms of an accompanying contractual obligation, entitles or requires the holder to acquire another security without payment of material additional consideration and obliges the issuer of the special warrant or the other security to undertake efforts to file a prospectus to qualify the distribution of the other security;

"specified asset-backed security" means a security that

(a) is primarily serviced by the cash flows of a discrete pool of receivables or other financial assets, either fixed or revolving, that by their terms convert into cash within a finite time, and any rights or assets designed to assure the servicing or timely distribution of proceeds to securityholders, and

(b) by its terms entitles an investor in that security to a return of the investment of that investor at or by a time established by or determinable by reference to an agreement, except as a result of losses incurred on, or the non-performance of, the financial assets;

"specified dealer" means a dealer other than a dealer whose activities as a dealer are restricted by the terms of its registration to one or both of

(a) acting solely in respect of mutual fund securities;

(b) acting solely in respect of transactions in which a person or company registered in the category of exempt market dealer in a jurisdiction is permitted to engage;

"specified derivative" means an instrument, agreement or security, the market price, value or payment obligations of which are derived from, referenced to or based on an underlying interest, other than

(a) a conventional convertible security,

(b) a specified asset-backed security,

(c) an index participation unit,

(d) a government or corporate strip bond,

(e) a capital, equity dividend or income share of a subdivided equity or fixed income security,

(f) a conventional warrant or right, or

(g) a special warrant;

"standardized future" means an agreement traded on a futures exchange pursuant to standardized conditions contained in the by-laws, rules or regulations of the futures exchange, and cleared by a clearing corporation, to do one or more of the following at a price established by or determinable by reference to the agreement and at or by a time established by or determinable by reference to the agreement:

1. Make or take delivery of the underlying interest of the agreement.

2. Settle the obligation in cash instead of delivery of the underlying interest;

"sub-custodian" means, for an investment fund, an entity that has been appointed to hold portfolio assets of the investment fund in accordance with section 6.1 by either the custodian or a sub-custodian of the investment fund;

"swap" means an agreement that provides for

(a) an exchange of principal amounts,

(b) the obligation to make, and the right to receive, cash payments based upon the value, level or price, or on relative changes or movements of the value, level or price, of one or more underlying interests, which payments may be netted against each other, or

(c) the right or obligation to make, and the right or obligation to receive, physical delivery of an underlying interest instead of the cash payments referred to in paragraph (b);

"synthetic cash" means a position that in aggregate provides the holder with the economic equivalent of the return on a banker's acceptance accepted by a bank listed in Schedule I of the *Bank Act* (Canada) and that consists of

(a) a long position in a portfolio of shares and a short position in a standardized future of which the underlying interest consists of a stock index, if

(i) there is a high degree of positive correlation between changes in the value of the portfolio of shares and changes in the value of the stock index, and

(ii) the ratio between the value of the portfolio of shares and the standardized future is such that, for any change in the value of one, a change of similar magnitude occurs in the value of the other,

(b) a long position in the evidences of indebtedness issued, or fully and unconditionally guaranteed as to principal and interest, by any of the government of Canada or the government of a jurisdiction and a short position in a standardized future of which the underlying interest consists of evidences of indebtedness of the same issuer and same term to maturity, if

(i) there is a high degree of positive correlation between changes in the value of the portfolio of evidences of indebtedness and changes in the value of the standardized future, and

(ii) the ratio between the value of the evidences of indebtedness and the standardized future is such that, for any change in the value of one, a change of similar magnitude occurs in the value of the other; or

(c) a long position in securities of an issuer and a short position in a standardized future of which the underlying interest is securities of that issuer, if the ratio between the value of the securities of that issuer and the position in the standardized future is such that, for any change in the value of one, a change of similar magnitude occurs in the value of the other;

"underlying interest" means, for a specified derivative, the security, commodity, financial instrument, currency, interest rate, foreign exchange rate, economic indicator, index, basket, agreement, benchmark or any other reference, interest or variable, and, if applicable, the relationship between any of the foregoing, from, to or on which the market price, value or payment obligation of the specified derivative is derived, referenced or based; and

"underlying market exposure" means, for a position of an investment fund in

(a) an option, the quantity of the underlying interest of the option position multiplied by the market value of one unit of the underlying interest, multiplied, in turn, by the delta of the option,

(b) a standardized future or forward contract, the quantity of the underlying interest of the position multiplied by the current market value of one unit of the underlying interest; or

(c) a swap, the underlying market exposure, as calculated under paragraph (b), for the long position of the investment fund in the swap.

1.2 Application – (1) This Instrument applies only to

(a) a mutual fund that offers or has offered securities under a prospectus for so long as the mutual fund remains a reporting issuer,

(a.1) a non-redeemable investment fund that is a reporting issuer, and

(b) a person or company in respect of activities pertaining to an investment fund referred to in paragraphs (a) and (a.1) or pertaining to the filing of a prospectus to which subsection 3.1(1) applies.

(2) Despite subsection (1), this Instrument does not apply to a scholarship plan.

(3) Despite subsection (1), in Québec, in respect of investment funds organized under an Act to establish the *Fonds de solidarité des travailleurs du Québec* (*F.T.Q.*) (chapter F-3.2.1), an Act to establish *Fondaction, le Fonds de développement de la Confédération des syndicats nationaux pour la coopération et l'emploi* (chapter F-3.1.2), or an Act constituting *Capital régional et coopératif Desjardins* (chapter C-6.1), the following requirements apply:

(a) sections ~~2.12~~2.6.1 and sections 2.7 to 2.17;

(b) Part 6;

(c) Part 15, except for paragraph 15.8(2)(b);

(d) Part 19;

(e) Part 20.

(4) For greater certainty, in British Columbia, if a provision of this Instrument conflicts or is inconsistent with a provision of the *Employee Investment Act* (British Columbia) or the *Small Business Venture Capital Act* (British Columbia), the provision of the Employee Investment Act or the Small Business Venture Capital Act, as the case may be, prevails.

1.3 Interpretation – (1) Each section, part, class or series of a class of securities of an investment fund that is referable to a separate portfolio of assets is considered to be a separate investment fund for purposes of this Instrument.

(2) An investment fund that renews or extends a securities lending, repurchase or reverse repurchase transaction is entering into a securities lending, repurchase or reverse repurchase agreement for the purposes of section 2.12, 2.13 or 2.14.

(3) [Repealed]

PART 2 INVESTMENTS

2.1 Concentration Restriction – (1) A mutual fund other than an alternative fund must not purchase a security of an issuer, enter into a specified derivatives transaction or purchase an index participation ~~units~~unit if, immediately after the transaction, more than 10 ~~percent~~% of its net asset value would be invested in securities of any one issuer.

(1.1) An alternative fund or a non-redeemable investment fund must not purchase a security of an issuer, enter into a specified derivatives transaction or purchase an index participation unit if, immediately after the transaction, more than 20 % of its net asset value would be invested in securities of any one issuer.

(2) ~~Subsection~~Subsections (1) ~~does~~and (1.1) do not apply to the purchase of any of the following:

(a) a government security;

(b) a security issued by a clearing corporation;

(c) a security issued by ~~a mutual~~an investment fund if the purchase is made in accordance with the requirements of section 2.5;

(d) an index participation unit that is a security of ~~a mutual~~an investment fund;

(e) an equity security if the purchase is made by a fixed portfolio ~~ETF~~investment fund in accordance with its investment objectives.

(3) In determining ~~a mutual~~an investment fund's compliance with the restrictions contained in this section, the ~~mutual~~investment fund must, for each long position in a specified derivative that is held by the ~~mutual~~investment fund for purposes other than hedging and for each index participation unit held by the ~~mutual~~investment fund, consider that it holds directly the underlying interest of that specified derivative or its proportionate share of the securities held by the issuer of the index participation unit.

(4) Despite subsection (3), the ~~mutual~~investment fund must not include in the determination referred to in subsection (3) a security or instrument that is a component of, but that represents less than 10% ~~percent~~ of

(a) a stock or bond index that is the underlying interest of a specified derivative; or

(b) the securities held by the issuer of an index participation unit.

(5) Despite subsection (1), an index mutual fund, the name of which includes the word "index", may, in order to satisfy its fundamental investment objectives, purchase a security, enter into a specified derivatives transaction or purchase index participation units if its prospectus contains the disclosure referred to in subsection (5) of Item 6 and subsection (5) of Item 9 of Part B of Form 81-101F1 *Contents of Simplified Prospectus*.

2.2 Control Restrictions – (1) An investment fund must not purchase a security of an issuer

(a) if, immediately after the purchase, the investment fund would hold securities representing more than 10% of

(i) the votes attaching to the outstanding voting securities of the issuer; or

(ii) the outstanding equity securities of the issuer; or

(b) for the purpose of exercising control over, or management of, the issuer.

(1.1) Subsection (1) does not apply to the purchase of any of the following:

(a) a security issued by an investment fund if the purchase is made in accordance with section 2.5;

(b) an index participation unit that is a security of an investment fund.

(2) If an investment fund acquires a security of an issuer other than as the result of a purchase, and the acquisition results in the investment fund exceeding the limits described in paragraph (1)(a), the investment fund must as quickly as is commercially reasonable, and in any event no later than 90 days after the acquisition, reduce its holdings of those securities so that it does not hold securities exceeding those limits.

(3) In determining its compliance with the restrictions contained in this section, an investment fund must

(a) assume the conversion of special warrants held by it; and

(b) consider that it holds directly the underlying securities represented by any American depositary receipts held by it.

2.3 Restrictions Concerning Types of Investments – (1) A mutual fund must not do any of the following:

(a) purchase real property;

(b) purchase a mortgage, other than a guaranteed mortgage;

(c) purchase a guaranteed mortgage if, immediately after the purchase, more than 10 percent of its net asset value would be made up of guaranteed mortgages;

(d) purchase a ~~gold~~precious metals certificate, other than a permitted ~~gold~~precious metals certificate;

(e) purchase ~~gold or~~permitted precious metals, a permitted ~~gold~~precious metal certificate, or a specified derivative the underlying interest of which is a physical commodity, if, immediately after the purchase, more than 10% percent of ~~its~~the mutual fund's net asset value would be made up of ~~gold and~~ permitted precious metals, permitted ~~gold~~precious metal certificates and specified derivatives the underlying interest of which is a physical commodity;

(f) purchase a physical commodity, except to the extent permitted by paragraphs (d) and (e)~~, purchase a physical commodity~~;

(g) purchase, sell or use a specified derivative other than in compliance with sections 2.7 to 2.11; or

(h) ~~purchase, sell or use a specified derivative the underlying interest of which is~~[repealed]

~~(i) a physical commodity other than gold, or~~

~~(ii) a specified derivative of which the underlying interest is a physical commodity other than gold; or~~

(i) purchase an interest in a loan syndication or loan participation if the purchase would require the mutual fund to assume any responsibilities in administering the loan in relation to the borrower.

(1.1) Paragraphs (1)(d), (e), (f), and (g) do not apply to an alternative fund.

(1.2) The restriction in paragraph (1)(e) does not apply to a precious metals fund with respect to purchasing permitted precious metals, a permitted precious metal certificate or a specified derivative the underlying interest of which is one or more permitted precious metals.

(2) A non-redeemable investment fund must not do any of the following:

(a) purchase real property;

(b) purchase a mortgage, other than a guaranteed mortgage;

(c) purchase an interest in a loan syndication, or loan participation, if the purchase would require the non-redeemable investment fund to assume any responsibilities in administering the loan in relation to the borrower.

(3) In determining an investment fund's compliance with the restrictions contained in this section, the investment fund must, for each long position in a specified derivative that is held by the investment fund for purposes other than hedging and for each index participation unit or underlying investment fund held by the investment fund, the investment fund must consider that it holds directly the underlying interest of that specified derivative or its proportionate share of the securities held by the issuer of the index participation unit or underlying investment fund, as applicable.

(4) Despite subsection (3), in the determination referred to in subsection (3) the investment fund must not include a security or instrument that is a component of, but that represents less than 10% of

(a) a stock or bond index that is the underlying interest of a specified derivative; or

(b) the securities held by the issuer of an index participation unit.

2.4 Restrictions Concerning Illiquid Assets – (1) A mutual fund must not purchase an illiquid asset if, immediately after the purchase, more than 10 ~~percent~~% of its net asset value would be made up of illiquid assets.

(2) A mutual fund must not have invested, for a period of 90 days or more, more than 15 ~~percent~~% of its net asset value in illiquid assets.

(3) If more than 15 ~~percent~~% of the net asset value of a mutual fund is made up of illiquid assets, the mutual fund must, as quickly as is commercially reasonable, take all necessary steps to reduce the percentage of its net asset value made up of illiquid assets to 15 ~~percent~~% or less.

(4) A non-redeemable investment fund must not purchase an illiquid asset if, immediately after the purchase, more than 20% of its net asset value would be made up of illiquid assets.

(5) A non-redeemable investment fund must not have invested, for a period of 90 days or more, more than 25% of its net asset value in illiquid assets.

(6) If more than 25% of the net asset value of a non-redeemable investment fund is made up of illiquid assets, the non-redeemable investment fund must, as quickly as is commercially reasonable, take all necessary steps to reduce the percentage of its net asset value made up of illiquid assets to 25% or less.

2.5 Investments in Other Investment Funds – (1) For the purposes of this section, an investment fund is considered to be holding a security of another investment fund if

(a) it holds securities issued by the other investment fund, or

(b) it is maintaining a position in a specified derivative for which the underlying interest is a security of the other investment fund.

(2) An investment fund must not purchase or hold a security of another investment fund unless~~,~~:

(a) if the investment fund is a mutual fund~~,~~ other than an alternative fund, either of the following apply:

(i) the other investment fund is a mutual fund other than an alternative fund, that is subject to this Instrument ~~and offers or has offered securities under a simplified prospectus in accordance with National Instrument 81-101 Mutual Fund Prospectus Disclosure,~~;

(ii) the other investment fund is an alternative fund or a non-redeemable investment fund that is subject to this Instrument, provided that the mutual fund must not purchase securities of the alternative fund or non-redeemable investment fund if, immediately after the purchase, more than 10% of its net asset value will be made up of securities of alternative funds and non-redeemable investment funds;

(a.1) if the investment fund is an alternative fund or a non-redeemable investment fund, one or both of the following apply:

(i) the other investment fund is subject to this Instrument;

(ii) the other investment fund complies with the provisions of this Instrument applicable to an alternative fund or a non-redeemable investment fund,

(b) at the time of the purchase of that security, the other investment fund holds no more than 10% of its net asset value in securities of other investment funds,

(c) the other investment fund is a reporting issuer in a jurisdiction,

(c) ~~if the investment fund is a mutual fund, the investment fund and the other investment fund are reporting issuers in the local jurisdiction,~~.1) [repealed],

~~(c.1) if the investment fund is a non-redeemable investment fund, the other investment fund is a reporting issuer in a jurisdiction in which the investment fund is a reporting issuer,~~

(d) no management fees or incentive fees are payable by the investment fund that, to a reasonable person, would duplicate a fee payable by the other investment fund for the same service,

(e) no sales fees or redemption fees are payable by the investment fund in relation to its purchases or redemptions of the securities of the other investment fund if the other investment fund is managed by the manager or an affiliate or associate of the manager of the investment fund, and

(f) no sales fees or redemption fees are payable by the investment fund in relation to its purchases or redemptions of securities of the other investment fund that, to a reasonable person, would duplicate a fee payable by an investor in the investment fund.

(3) Paragraphs (2)(a), (a.1)~~, (c),~~ and (c~~.1~~) do not apply if the security

(a) is an index participation unit issued by an investment fund, or

(b) is issued by another investment fund established with the approval of the government of a foreign jurisdiction and the only means by which the foreign jurisdiction permits investment in the securities of issuers of that foreign jurisdiction is through that type of investment fund.

(4) Paragraph (2)(b) does not apply if the other investment fund

(a) is a clone fund, or

(b) in accordance with this section purchases or holds securities

(i) of a money market fund, or

(ii) that are index participation units issued by an investment fund.

(5) Paragraphs (2)(e) and (f) do not apply to brokerage fees incurred for the purchase or sale of an index participation unit issued by an investment fund.

(6) An investment fund that holds securities of another investment fund that is managed by the same manager or an affiliate or associate of the manager

(a) must not vote any of those securities, and

(b) may, if the manager so chooses, arrange for all of the securities it holds of the other investment fund to be voted by the beneficial holders of securities of the investment fund.

(7) The investment fund conflict of interest investment restrictions and the investment fund conflict of interest reporting requirements do not apply to an investment fund which purchases or holds securities of another investment fund if the purchase or holding is made in accordance with this section.

2.6 Investment Practices – (1) An investment fund must not,

(a) ~~in the case of a mutual fund,~~ borrow cash or provide a security interest over any of its portfolio assets unless

(i) the transaction is a temporary measure to accommodate requests for the redemption of securities of the ~~mutual~~investment fund while the ~~mutual~~investment fund effects an orderly liquidation of portfolio assets, or to permit the ~~mutual~~investment fund to settle portfolio transactions and, after giving effect to all transactions undertaken under this subparagraph, the outstanding amount of all borrowings of the ~~mutual~~investment fund does not exceed ~~five percent~~5% of its net asset value at the time of the borrowing,

(ii) the security interest is required to enable the ~~mutual~~investment fund to effect a specified derivative transaction or short sale of securities under this Instrument, is made in accordance with industry practice for that type of transaction and relates only to obligations arising under the particular specified derivatives transaction or short sale,

(iii) the security interest secures a claim for the fees and expenses of the custodian or a sub-custodian of the ~~mutual~~investment fund for services rendered in that capacity as permitted by subsection 6.4(3), or

(iv) in the case of an exchange-traded mutual fund that is not in continuous distribution or a non-redeemable investment fund, the transaction is to finance the acquisition of its portfolio securities and the outstanding amount of all borrowings is repaid on the closing of its initial public offering;

(b) ~~in the case of a mutual fund,~~ purchase securities on margin, unless permitted by section 2.7 or 2.8;

(c) ~~in the case of a mutual fund,~~ sell securities short other than in compliance with section 2.6.1, unless permitted by section 2.7 or 2.8;

(d) purchase a security, other than a specified derivative, that by its terms may require the investment fund to make a contribution in addition to the payment of the purchase price;

(e) engage in the business of underwriting, or marketing to the public, securities of any other issuer;

(f) lend cash or portfolio assets other than cash;

(g) guarantee securities or obligations of a person or company; or

(h) purchase securities other than through market facilities through which these securities are normally bought and sold unless the purchase price approximates the prevailing market
price or the parties are at arm's length in connection with the transaction.

(2) An alternative fund or a non-redeemable investment fund may borrow cash in excess of the limits set out in subsection (1) provided that each of the following applies:

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

(b) if the lender is an affiliate of the investment fund manager of the alternative fund or non-redeemable investment fund, the independent review committee must approve the applicable borrowing agreement under subsection 5.2(2) of NI 81-107;

(c) the borrowing agreement entered into is in accordance with normal industry practice and on standard commercial terms for the type of transaction; and

(d) the total value of cash borrowed must not exceed 50% of the alternative fund or non-redeemable investment fund's net asset value.

2.6.1 Short Sales – (1) ~~A mutual~~An investment fund may sell a security short if

(a) the security sold short is sold for cash;

(b) the security sold short is not any of the following:

(i) a security that the ~~mutual~~investment fund is otherwise not permitted by securities legislation to purchase at the time of the short sale transaction;

(ii) an illiquid asset;

(iii) a security of an investment fund other than an index participation unit; and

(c) at the time the ~~mutual~~investment fund sells the security short,

(i) the ~~mutual~~investment fund has borrowed or arranged to borrow from a borrowing agent the security that is to be sold under the short sale~~;~~,

(ii) if the investment fund is a mutual fund other than an alternative fund, the aggregate market value of all securities of the issuer of the securities sold short by the mutual fund does not exceed 5% of the net asset value of the mutual fund~~; and~~,

(iii) ~~(iii)~~ if the investment fund is a mutual fund other than an alternative fund, the aggregate market value of all securities sold short by the mutual fund does not exceed 20% of the net asset value of the mutual fund,

(iv) if the investment fund is an alternative fund or a non-redeemable investment fund, the aggregate market value of all securities of the issuer of the securities sold short by the investment fund does not exceed 10% of the net asset value of the investment fund, and

(v) if the investment fund is an alternative fund or a non-redeemable investment fund, the aggregate market value of all securities sold short by the investment fund does not exceed 50% of the net asset value of the investment fund.

(2) A mutual fund other than an alternative fund that sells securities short must hold cash cover in an amount that, together with portfolio assets deposited with borrowing agents as security in connection with short sales of securities by the mutual fund, is at least 150% of the aggregate market value of all securities sold short by the mutual fund on a daily mark-to-market basis.

(3) A mutual fund other than an alternative fund must not use the cash from a short sale to enter into a long position in a security, other than a security that qualifies as cash cover.

2.6.2 Total Borrowing and Short Selling – (1) Despite sections 2.6 and 2.6.1, an investment fund must not borrow cash or sell securities short, if immediately after entering into a cash borrowing or short selling transaction, the aggregate value of cash borrowed combined with the aggregate market value of all securities sold short by the investment fund would exceed 50% of the investment fund's net asset value.

(2) Despite sections 2.6 and 2.6.1, if the aggregate value of cash borrowed combined with the aggregate market value of all securities sold short by the investment fund exceeds 50% of the investment fund's net asset value, the investment fund must, as quickly as commercially reasonable take all necessary steps to reduce the aggregate value of cash borrowed combined with the aggregate market value of securities sold short to 50% or less of the investment fund's net asset value.

2.7 Transactions in Specified Derivatives for Hedging and Non-hedging Purposes – (1) ~~A mutual~~An investment fund must not purchase an option or a debt-like security or enter into a swap or a forward contract unless, at the time of the transaction, any of the following apply:

(a) in the case of an option, the option is a clearing corporation option;

(b) the option, debt-like security, swap or contract, has a designated rating;

(c) the equivalent debt of the counterparty, or of a person or company that has fully and unconditionally guaranteed the obligations of the counterparty in respect of the option, debt-like security, swap or contract, has a designated rating; and

(d) the option, debt-like security, swap or contract is a cleared specified derivative.

(2) If the credit rating of an option that is not a clearing corporation option, the credit rating of a debt-like security, swap or forward contract, or the credit rating of the equivalent debt of the writer or guarantor of the option, debt-like security, swap or contract, falls below the level of designated rating while the option, debt-like security, swap or contract is held by ~~a mutual~~an investment fund , the ~~mutual~~investment fund must take the steps that are reasonably required to close out its position in the option, debt-like security, swap or contract in an orderly and timely fashion.

(3) Despite any other provisions contained in this Part, ~~a mutual~~an investment fund may enter into a trade to close out all or part of a position in a specified derivative, in which case the cash cover held to cover the underlying market exposure of the part of the position that is closed out may be released.

(4) The mark-to-market value of the exposure of ~~a mutual~~an investment fund under its specified derivatives positions, other than for positions in cleared specified derivatives, with any one counterparty ~~other than an acceptable clearing corporation or a clearing corporation that clears and settles transactions made on a futures exchange listed in Appendix A~~, calculated in accordance with subsection (5), must not exceed, for a period of 30 days or more, 10 ~~percent~~% of the net asset value of the ~~mutual~~investment fund.

(5) The mark-to-market value of specified derivatives positions of ~~a mutual~~an investment fund with any one counterparty must be, for the purposes of subsection (4),

(a) if the ~~mutual~~investment fund has an agreement with the counterparty that provides for netting or the right of set-off, the net mark-to-market value of the specified derivatives positions of the ~~mutual~~investment fund; and

(b) in all other cases, the aggregated mark-to-market value of the specified derivative positions of the ~~mutual~~investment fund.

(6) Subsections (1), (2) and (3) do not apply to an alternative fund or a non-redeemable investment fund.

2.8 Transactions in Specified Derivatives for Purposes Other than Hedging – (0.1) This section does not apply to an alternative fund.

(1) A mutual fund must not

(a) purchase a debt-like security that has an options component or an option, unless, immediately after the purchase, not more than 10 percent of its net asset value would be made up of those instruments held for purposes other than hedging;

(b) write a call option, or have outstanding a written call option, that is not an option on futures unless, as long as the position remains open, the mutual fund holds

(i) an equivalent quantity of the underlying interest of the option,

(ii) a right or obligation, exercisable at any time that the option is exercisable, to acquire an equivalent quantity of the underlying interest of the option, and cash cover that, together with margin on account for the position, is not less than the amount, if any, by which the strike price of the right or obligation to acquire the underlying interest exceeds the strike price of the option, or

(iii) a combination of the positions referred to in subparagraphs (i) and (ii) that is sufficient, without recourse to other assets of the mutual fund, to enable the mutual fund to satisfy its obligations to deliver the underlying interest of the option;

(c) write a put option, or have outstanding a written put option, that is not an option on futures, unless, as long as the position remains open, the mutual fund holds

(i) a right or obligation, exercisable at any time that the option is exercisable, to sell an equivalent quantity of the underlying interest of the option, and cash cover in an amount that, together with margin on account for the position, is not less than the amount, if any, by which the strike price of the option exceeds the strike price of the right or obligation to sell the underlying interest,

(ii) cash cover that, together with margin on account for the option position, is not less than the strike price of the option, or

(iii) a combination of the positions referred to in subparagraphs (i) and (ii) that is sufficient, without recourse to other assets of the mutual fund, to enable the mutual fund to acquire the underlying interest of the option;

(d) open or maintain a long position in a debt-like security that has a component that is a long position in a forward contract, or in a standardized future or forward contract, unless the mutual fund holds cash cover in an amount that, together with margin on account for the specified derivative and the market value of the specified derivative, is not less than, on a daily mark-to-market basis, the underlying market exposure of the specified derivative;

(e) open or maintain a short position in a standardized future or forward contract, unless the mutual fund holds

(i) an equivalent quantity of the underlying interest of the future or contract,

(ii) a right or obligation to acquire an equivalent quantity of the underlying interest of the future or contract and cash cover that together with margin on account for the position is not less than the amount, if any, by which the

strike price of the right or obligation to acquire the underlying interest exceeds the forward price of the contract, or

(iii) a combination of the positions referred to in subparagraphs (i) and (ii) that is sufficient, without recourse to other assets of the mutual fund, to enable the mutual fund to deliver the underlying interest of the future or contract; or

(f) enter into, or maintain, a swap position unless

(i) for periods when the mutual fund would be entitled to receive payments under the swap, the mutual fund holds cash cover in an amount that, together with margin on account for the swap and the market value of the swap, is not less than, on a daily mark-to-market basis, the underlying market exposure of the swap; and

(ii) for periods when the mutual fund would be required to make payments under the swap, the mutual fund holds

(A) an equivalent quantity of the underlying interest of the swap,

(B) a right or obligation to acquire an equivalent quantity of the underlying interest of the swap and cash cover that, together with margin on account for the position, is not less than the aggregate amount of the obligations of the mutual fund under the swap, or

(C) a combination of the positions referred to in clauses (A) and (B) that is sufficient, without recourse to other assets of the mutual fund, to enable the mutual fund to satisfy its obligations under the swap.

(2) A mutual fund must treat any synthetic cash position on any date as providing the cash cover equal to the notional principal value of a banker's acceptance then being accepted by a bank listed in Schedule I of the *Bank Act* (Canada) that would produce the same annualized return as the synthetic cash position is then producing.

2.9 Transactions in Specified Derivatives for Hedging Purposes – (1) Sections 2.1, 2.2, 2.4 and 2.8 do not apply to the use of specified derivatives by a mutual fund for hedging purposes.

(2) Section 2.2 does not apply to the use of specified derivatives by a non-redeemable investment fund for hedging purposes.

2.9.1 Leverage – (1) An investment fund's aggregate gross exposure must not exceed 3 times the investment fund's net asset value.

(2) For the purposes of subsection (1), an investment fund's aggregate gross exposure must be calculated as the sum of the following, divided by the investment fund's net asset value:

(a) the aggregate value of the investment fund's indebtedness under any borrowing agreements entered into pursuant to section 2.6,

(b) the aggregate market value of securities sold short by the investment fund pursuant to section 2.6.1, and

(c) the aggregate notional amount of the investment's fund's specified derivatives positions.

(3) In determining an investment fund's compliance with the restriction contained in this section, the investment fund must also include in its calculation its proportionate shares of securities of any underlying investment funds for which a similar calculation is required.

(4) An investment fund must determine its compliance with the restriction contained in this section as of the close of business of each day on which the investment fund calculates a net asset value.

(5) If the investment fund's aggregate gross exposure as determined in subsection (2) exceeds 3 times the investment fund's net asset value, the investment fund must, as quickly as is commercially reasonable, take all necessary steps to reduce the aggregate gross exposure to 3 times the investment fund's net asset value or less.

2.10 Adviser Requirements – (1) If a portfolio adviser of an investment fund receives advice from a non-resident sub-adviser concerning the use of options or standardized futures by the investment fund, the investment fund must not invest in or use options or standardized futures unless

(a) the obligations and duties of the non-resident sub-adviser are set out in a written agreement with the portfolio adviser; and

(b) the portfolio adviser contractually agrees with the investment fund to be responsible for any loss that arises out of the failure of the non-resident sub-adviser

(i) to exercise the powers and discharge the duties of its office honestly, in good faith and in the best interests of the investment fund, and

(ii) to exercise the degree of care, diligence and skill that a reasonably prudent person would exercise in the circumstances.

(2) An investment fund must not relieve a portfolio adviser of the investment fund from liability for loss for which the portfolio adviser has assumed responsibility under paragraph (1)(b) that arises out of the failure of the relevant non-resident sub-adviser

(a) to exercise the powers and discharge the duties of its office honestly, in good faith and in the best interests of the investment fund, or

(b) to exercise the degree of care, diligence and skill that a reasonably prudent person would exercise in the circumstances.

(3) Despite subsection 4.4(3), an investment fund may indemnify a portfolio adviser against legal fees, judgments and amounts paid in settlement, actually and reasonably incurred by that person or company in connection with services provided by a non-resident sub-

adviser for which the portfolio adviser has assumed responsibility under paragraph (1)(b), only if

(a) those fees, judgments and amounts were not incurred as a result of a breach of the standard of care described in subsection (1) or (2); and

(b) the investment fund has reasonable grounds to believe that the action or inaction that caused the payment of the fees, judgments and amounts paid in settlement was in the best interests of the investment fund.

(4) An investment fund must not incur the cost of any portion of liability insurance that insures a person or company for a liability except to the extent that the person or company may be indemnified for that liability under this section.

2.11 Commencement of Use of Specified Derivatives and Short Selling by an Investment Fund – (0.1) This section does not apply to an alternative fund.

(1) An investment fund that has not used specified derivatives must not begin using specified derivatives, and an investment fund that has not sold a security short in accordance with section 2.6.1 must not sell a security short, unless,

(a) in the case of a mutual fund, other than an exchange-traded mutual fund that is not in continuous distribution, its prospectus contains the disclosure required for a mutual fund intending to engage in the activity;

(a.1) in the case of an exchange-traded mutual fund that is not in continuous distribution or of a non-redeemable investment fund, the investment fund issues a news release that contains both of the following:

(i) the disclosure required in a prospectus for an exchange-traded mutual fund that is not in continuous distribution, or a non-redeemable investment fund, intending to engage in the activity;

(ii) the date on which the activity is intended to begin; and

(b) the investment fund has provided to its securityholders, not less than 60 days before it begins the intended activity, written notice that discloses its intent to engage in the activity and the disclosure referred to in paragraph (a) or (a.1), as applicable.

(2) A mutual fund, other than an exchange-traded mutual fund that is not in continuous distribution, is not required to provide the notice referred to in paragraph (1)(b) if each prospectus of the mutual fund since its inception has contained the disclosure referred to in paragraph (1)(a).

(3) Subsection (1) does not apply to an exchange-traded mutual fund that is not in continuous distribution, or to a non-redeemable investment fund, if each prospectus of the investment fund filed since its inception has contained the disclosure referred to in paragraph (1)(a.1).

2.12 Securities Loans – (1) Despite any other provision of this Instrument, an investment fund may enter into a securities lending transaction as lender if the following conditions are satisfied for the transaction:

1. The transaction is administered and supervised in the manner required by sections 2.15 and 2.16.

2. The transaction is made under a written agreement that implements the requirements of this section.

3. Securities are loaned by the investment fund in exchange for collateral.

4. The securities transferred, either by the investment fund or to the investment fund as collateral, as part of the transaction are immediately available for good delivery under applicable legislation.

5. The collateral to be delivered to the investment fund at the beginning of the transaction

   (a) is received by the investment fund either before or at the same time as it delivers the loaned securities; and

   (b) has a market value equal to at least 102 percent of the market value of the loaned securities.

6. The collateral to be delivered to the investment fund is one or more of

   (a) cash;

   (b) qualified securities;

   (c) securities that are immediately convertible into, or exchangeable for, securities of the same issuer, class or type, and the same term, if applicable, as the securities that are being loaned by the investment fund, and in at least the same number as those loaned by the investment fund; or

   (d) irrevocable letters of credit issued by a Canadian financial institution that is not the counterparty, or an affiliate of the counterparty, of the investment fund in the transaction, if evidences of indebtedness of the Canadian financial institution that are rated as short term debt by a designated rating organization or its DRO affiliate have a designated rating.

7. The collateral and loaned securities are marked to market on each business day, and the amount of collateral in the possession of the investment fund is adjusted on each business day to ensure that the market value of collateral maintained by the investment fund in connection with the transaction is at least 102 percent of the market value of the loaned securities.

8. If an event of default by a borrower occurs, the investment fund, in addition to any other remedy available under the agreement or applicable law, has the

right under the agreement to retain and dispose of the collateral to the extent necessary to satisfy its claims under the agreement.

9. The borrower is required to pay promptly to the investment fund amounts equal to and as compensation for all dividends and interest paid, and all distributions made, on the loaned securities during the term of the transaction.

10. The transaction is a "securities lending arrangement" under section 260 of the ITA.

11. The investment fund is entitled to terminate the transaction at any time and recall the loaned securities within the normal and customary settlement period for securities lending transactions in the market in which the securities are lent.

12. Immediately after the investment fund enters into the transaction, the aggregate market value of all securities loaned by the investment fund in securities lending transactions and not yet returned to it or sold by the investment fund in repurchase transactions under section 2.13 and not yet repurchased does not exceed 50% of the net asset value of the investment fund.

(2) An investment fund may hold all cash delivered to it as the collateral in a securities lending transaction or may use the cash to purchase

(a) qualified securities having a remaining term to maturity no longer than 90 days;

(b) securities under a reverse repurchase agreement permitted by section 2.14; or

(c) a combination of the securities referred to in paragraphs (a) and (b).

(3) An investment fund, during the term of a securities lending transaction, must hold all, and must not invest or dispose of any, non-cash collateral delivered to it as collateral in the transaction.

2.13 Repurchase Transactions – (1) Despite any other provision of this Instrument, an investment fund may enter into a repurchase transaction if the following conditions are satisfied for the transaction:

1. The transaction is administered and supervised in the manner required by sections 2.15 and 2.16.

2. The transaction is made under a written agreement that implements the requirements of this section.

3. Securities are sold for cash by the investment fund, with the investment fund assuming an obligation to repurchase the securities for cash.

4. The securities transferred by the investment fund as part of the transaction are immediately available for good delivery under applicable legislation.

5. The cash to be delivered to the investment fund at the beginning of the transaction

   (a) is received by the investment fund either before or at the same time as it delivers the sold securities; and

   (b) is in an amount equal to at least 102 percent of the market value of the sold securities.

6. The sold securities are marked to market on each business day, and the amount of sale proceeds in the possession of the investment fund is adjusted on each business day to ensure that the amount of cash maintained by the investment fund in connection with the transaction is at least 102 percent of the market value of the sold securities.

7. If an event of default by a purchaser occurs, the investment fund, in addition to any other remedy available under the agreement or applicable law, has the right under the agreement to retain or dispose of the sale proceeds delivered to it by the purchaser to the extent necessary to satisfy its claims under the agreement.

8. The purchaser of the securities is required to pay promptly to the investment fund amounts equal to and as compensation for all dividends and interest paid, and all distributions made, on the sold securities during the term of the transaction.

9. The transaction is a "securities lending arrangement" under section 260 of the ITA.

10. The term of the repurchase agreement, before any extension or renewal that requires the consent of both the investment fund and the purchaser, is not more than 30 days.

11. Immediately after the investment fund enters into the transaction, the aggregate market value of all securities loaned by the investment fund in securities lending transactions under section 2.12 and not yet returned to it or sold by the investment fund in repurchase transactions and not yet repurchased does not exceed 50% of the net asset value of the investment fund.

(2) An investment fund may hold cash delivered to it as consideration for sold securities in a repurchase transaction or may use the cash to purchase

   (a) qualified securities having a remaining term to maturity no longer than 30 days;

   (b) securities under a reverse repurchase agreement permitted by section 2.14; or

   (c) a combination of the securities referred to in paragraphs (a) and (b).

2.14 Reverse Repurchase Transactions – (1) Despite any other provision of this Instrument, an investment fund may enter into a reverse repurchase transaction if the following conditions are satisfied for the transaction:

1. The transaction is administered and supervised in the manner required by sections 2.15 and 2.16.

2. The transaction is made under a written agreement that implements the requirements of this section.

3. Qualified securities are purchased for cash by the investment fund, with the investment fund assuming the obligation to resell them for cash.

4. The securities transferred as part of the transaction are immediately available for good delivery under applicable legislation.

5. The securities to be delivered to the investment fund at the beginning of the transaction

   (a) are received by the investment fund either before or at the same time as it delivers the cash used by it to purchase those securities; and

   (b) have a market value equal to at least 102 percent of the cash paid for the securities by the investment fund.

6. The purchased securities are marked to market on each business day, and either the amount of cash paid for the purchased securities or the amount of purchased securities in the possession of the seller or the investment fund is adjusted on each business day to ensure that the market value of purchased securities held by the investment fund in connection with the transaction is not less than 102 percent of the cash paid by the investment fund.

7. If an event of default by a seller occurs, the investment fund, in addition to any other remedy available in the agreement or applicable law, has the right under the agreement to retain or dispose of the purchased securities delivered to it by the seller to the extent necessary to satisfy its claims under the agreement.

8. The transaction is a “securities lending arrangement” under section 260 of the ITA.

9. The term of the reverse repurchase agreement, before any extension or renewal that requires the consent of both the seller and the investment fund, is not more than 30 days.

2.15 Agent for Securities Lending, Repurchase and Reverse Repurchase Transactions – (1) The manager of an investment fund must appoint an agent or agents to act on behalf of the investment fund to administer the securities lending and repurchase transactions entered into by the investment fund.

(2) The manager of an investment fund may appoint an agent or agents to act on behalf of the investment fund to administer the reverse repurchase transactions entered into by the investment fund.

(3) The custodian or a sub-custodian of the investment fund must be the agent appointed under subsection (1) or (2).

(4) The manager of an investment fund must not authorize an agent to enter into a securities lending, repurchase or, if applicable, reverse repurchase transactions on behalf of the investment fund until the agent enters into a written agreement with the manager and the investment fund in which

(a) the investment fund and the manager provide instructions to the agent on the parameters to be followed in entering into the type of transactions to which the agreement pertains;

(b) the agent agrees to comply with this Instrument, accepts the standard of care referred to in subsection (5) and agrees to ensure that all transactions entered into by it on behalf of the investment fund will comply with this Instrument; and

(c) the agent agrees to provide to the investment fund and the manager regular, comprehensive and timely reports summarizing the investment fund's securities lending, repurchase and reverse repurchase transactions, as applicable.

(5) An agent appointed under this section, in administering the securities lending, repurchase and, if applicable, reverse repurchase transactions of the investment fund must exercise the degree of care, diligence and skill that a reasonably prudent person would exercise in the circumstances.

2.16 Controls and Records – (1) An investment fund must not enter into transactions under sections 2.12, 2.13 or 2.14 unless,

(a) for transactions to be entered into through an agent appointed under section 2.15, the manager has reasonable grounds to believe that the agent has established and maintains appropriate internal controls and procedures and records; and

(b) for reverse repurchase transactions directly entered into by the investment fund without an agent, the manager has established and maintains appropriate internal controls, procedures and records.

(2) The internal controls, procedures and records referred to in subsection (1) must include

(a) a list of approved borrowers, purchasers and sellers based on generally accepted creditworthiness standards;

(b) as applicable, transaction and credit limits for each counterparty; and

(c) collateral diversification standards.

(3) The manager of an investment fund must, on a periodic basis not less frequently than annually,

(a) review the agreements with any agent appointed under section 2.15 to determine if the agreements are in compliance with this Instrument;

(b) review the internal controls described in subsection (2) to ensure their continued adequacy and appropriateness;

(c) make reasonable enquiries as to whether the agent is administering the securities lending, repurchase or reverse repurchase transactions of the investment fund in a competent and responsible manner, in conformity with the requirements of this Instrument and in conformity with the agreement between the agent, the manager and the investment fund entered into under subsection 2.15(4);

(d) review the terms of any agreement between the investment fund and an agent entered into under subsection 2.15(4) in order to determine if the instructions provided to the agent in connection with the securities lending, repurchase or reverse repurchase transactions of the investment fund continue to be appropriate; and

(e) make or cause to be made any changes that may be necessary to ensure that

(i) the agreements with agents are in compliance with this Instrument,

(ii) the internal controls described in subsection (2) are adequate and appropriate,

(iii) the securities lending, repurchase or reverse repurchase transactions of the investment fund are administered in the manner described in paragraph (c), and

(iv) the terms of each agreement between the investment fund and an agent entered into under subsection 2.15(4) are appropriate.

2.17 Commencement of Securities Lending, Repurchase and Reverse Repurchase Transactions by an Investment Fund – (1) An investment fund must not enter into securities lending, repurchase or reverse repurchase transactions unless,

(a) in the case of a mutual fund, other than an exchange-traded mutual fund that is not in continuous distribution, its prospectus contains the disclosure required for mutual funds entering into those types of transactions;

(b) in the case of an exchange-traded mutual fund that is not in continuous distribution or of a non-redeemable investment fund, the investment fund issues a news release that contains both of the following:

(i) the disclosure required in a prospectus for an exchange-traded mutual fund that is not in continuous distribution, or a non-redeemable investment fund, entering into those types of transactions;

(ii) the date on which the investment fund intends to begin entering into those types of transactions; and

(c) the investment fund provides to its securityholders, at least 60 days before it begins entering into those types of transactions, written notice that discloses its intent to begin entering into those types of transactions and the disclosure referred to in paragraph (a) or (b), as applicable.

(2) Paragraph (1)(c) does not apply to a mutual fund that has entered into reverse repurchase agreements as permitted by a decision of the securities regulatory authority or regulator.

(3) Paragraph (1)(c) does not apply to a mutual fund, other than an exchange-traded mutual fund that is not in continuous distribution, if each prospectus of the mutual fund filed since its inception contains the disclosure referred to in paragraph (1)(a).

(4) Subsection (1) does not apply to an exchange-traded mutual fund that is not in continuous distribution, or to a non-redeemable investment fund, if each prospectus of the investment fund filed since its inception contains the disclosure referred to in paragraph (1)(b).

2.18 Money Market Fund – (1) A mutual fund must not describe itself as a "money market fund" in its prospectus, a continuous disclosure document or a sales communication unless

(a) it has all of its assets invested in one or more of the following:

(i) cash,

(ii) cash equivalents,

(iii) an evidence of indebtedness that has a remaining term to maturity of 365 days or less and a designated rating,

(iv) a floating rate evidence of indebtedness if

(A) the floating interest rate of the indebtedness is reset no later than every 185 days, and

(B) the principal amount of the indebtedness will continue to have a market value of approximately par at the time of each change in the rate to be paid to the holders of the evidence of indebtedness, or

(v) securities issued by one or more money market funds,

(b) it has a portfolio of assets, excluding a security described in subparagraph (a)(v), with a dollar-weighted average term to maturity not exceeding

(i) 180 days, and

(ii) 90 days when calculated on the basis that the term of a floating rate obligation is the period remaining to the date of the next rate setting,

(c) not less than 95% of its assets invested in accordance with paragraph (a) are denominated in a currency in which the net asset value per security of the mutual fund is calculated, and

(d) it has not less than

(i) 5% of its assets invested in cash or readily convertible into cash within one day, and

(ii) 15% of its assets invested in cash or readily convertible into cash within one week.

(2) Despite any other provision of this Instrument, a mutual fund that describes itself as a "money market fund" must not use a specified derivative or sell securities short.

(3) A non-redeemable investment fund must not describe itself as a "money market fund".

PART 3 NEW MUTUAL FUNDS

3.1 Initial Investment in a New Mutual Fund – (1) A person or company must not file a prospectus for a newly established mutual fund unless

(a) an investment of at least $150,000 in securities of the mutual fund has been made, and those securities are beneficially owned, before the time of filing by

(i) the manager, a portfolio adviser, a promoter or a sponsor of the mutual fund,

(ii) the partners, directors, officers or securityholders of any of the manager, a portfolio adviser, a promoter or a sponsor of the mutual fund, or

(iii) a combination of the persons or companies referred to subparagraphs (i) and (ii); or

(b) the prospectus of the mutual fund states that the mutual fund will not issue securities other than those referred to in paragraph (a) unless subscriptions aggregating not less than $500,000 have been received by the mutual fund from investors other than the persons and companies referred to in paragraph (a) and accepted by the mutual fund.

(2) A mutual fund must not redeem a security issued upon an investment in the mutual fund referred to in paragraph (1)(a) until $500,000 has been received from persons or companies other than the persons and companies referred to in paragraph (1)(a).

3.2 Prohibition Against Distribution – If a prospectus of a mutual fund contains the disclosure described in paragraph 3.1(1)(b), the mutual fund must not distribute any securities unless the subscriptions described in that disclosure, together with payment for the securities subscribed for, have been received.

3.3 Prohibition Against Reimbursement of Organization Costs – (1) The costs of incorporation, formation or initial organization of a mutual fund, or of the preparation and filing of any of the preliminary prospectus, preliminary annual information form, preliminary fund facts document, initial prospectus, annual information form or fund facts document of the mutual fund must not be borne by the mutual fund or its securityholders.

(2) Subsection (1) does not apply to an exchange-traded mutual fund unless the fund is in continuous distribution.

PART 4 CONFLICTS OF INTEREST

4.1 Prohibited Investments – (1) A dealer managed investment fund must not knowingly make an investment in a class of securities of an issuer during, or for 60 days after, the period in which the dealer manager of the investment fund, or an associate or affiliate of the dealer manager of the investment fund, acts as an underwriter in the distribution of securities of that class of securities, except as a member of the selling group distributing five percent or less of the securities underwritten.

(2) A dealer managed investment fund must not knowingly make an investment in a class of securities of an issuer of which a partner, director, officer or employee of the dealer manager of the investment fund, or a partner, director, officer or employee of an affiliate or associate of the dealer manager, is a partner, director or officer, unless the partner, director, officer or employee

(a) does not participate in the formulation of investment decisions made on behalf of the dealer managed investment fund;

(b) does not have access before implementation to information concerning investment decisions made on behalf of the dealer managed investment fund; and

(c) does not influence, other than through research, statistical and other reports generally available to clients, the investment decisions made on behalf of the dealer managed investment fund.

(2) Subsections (1) and (2) do not apply to an investment in a class of securities issued or fully and unconditionally guaranteed by the government of Canada or the government of a jurisdiction.

(4) Subsection (1) does not apply to an investment in a class of securities of an issuer if, at the time of each investment

(a) the independent review committee of the dealer managed investment fund has approved the transaction under subsection 5.2(2) of NI 81-107;

(b) in a class of debt securities of an issuer other than a class of securities referred to in subsection (3), the security has been given, and continues to have, a designated rating by a designated rating organization or its DRO affiliate;

(c) in any other class of securities of an issuer,

(i) the distribution of the class of equity securities is made by prospectus filed with one or more securities regulatory authorities or regulators in Canada, and

(ii) during the 60 day period referred to in subsection (1) the investment is made on an exchange on which the class of equity securities of the issuer is listed and traded; and

(d) no later than the time the dealer managed investment fund files its annual financial statements, the manager of the dealer managed investment fund files the particulars of each investment made by the dealer managed investment fund during its most recently completed financial year.

(4.1) In paragraph (4)(b), "designated rating" has the meaning ascribed to it in National Instrument 44-101 – *Short Form Prospectus Distributions*.

(5) The provisions of securities legislation that are referred to in Appendix C do not apply with respect to an investment in a class of securities of an issuer referred to in subsection (4) if the investment is made in accordance with that subsection.

4.2 Self-Dealing – (1) An investment fund must not purchase a security from, sell a security to, or enter into a securities lending, repurchase or reverse repurchase transaction under section 2.12, 2.13 or 2.14 with, any of the following persons or companies:

1. The manager, portfolio adviser or trustee of the investment fund.

2. A partner, director or officer of the investment fund or of the manager, portfolio adviser or trustee of the investment fund.

3. An associate or affiliate of a person or company referred to in paragraph 1 or 2.

4. A person or company, having fewer than 100 securityholders of record, of which a partner, director or officer of the investment fund or a partner, director or officer of the manager or portfolio adviser of the investment fund is a partner, director, officer or securityholder.

(2) Subsection (1) applies in the case of a sale of a security to, or a purchase of a security from, an investment fund only if the person or company that would be selling to, or purchasing from, the investment fund would be doing so as principal.

4.3 Exception – (1) Section 4.2 does not apply to a purchase or sale of a security by an investment fund if the price payable for the security is:

(a) not more than the ask price of the security as reported by any available public quotation in common use, in the case of a purchase by the investment fund; or

(b) not less than the bid price of the security as reported by any available public quotation in common use, in the case of a sale by the investment fund.

(2) Section 4.2 does not apply to a purchase or sale of a class of debt securities by an investment fund from, or to, another investment fund managed by the same manager or an affiliate of the manager, if, at the time of the transaction

(a) the investment fund is purchasing from, or selling to, another investment fund to which NI 81-107 applies;

(b) the independent review committee of the investment fund has approved the transaction under subsection 5.2(2) of NI 81-107; and

(c) the transaction complies with subsection 6.1(2) of NI 81-107.

4.4 Liability and Indemnification – (1) An agreement or declaration of trust by which a person or company acts as manager of an investment fund must provide that the manager is responsible for any loss that arises out of the failure of the manager, or of any person or company retained by the manager or the investment fund to discharge any of the manager's responsibilities to the investment fund,

(a) to exercise the powers and discharge the duties of its office honestly, in good faith and in the best interests of the investment fund, and

(b) to exercise the degree of care, diligence and skill that a reasonably prudent person would exercise in the circumstances.

(2) An investment fund must not relieve the manager of the investment fund from liability for loss that arises out of the failure of the manager, or of any person retained by the manager or the investment fund to discharge any of the manager's responsibilities to the investment fund,

(a) to exercise the powers and discharge the duties of its office honestly, in good faith and in the best interests of the investment fund, or

(b) to exercise the degree of care, diligence and skill that a reasonably prudent person would exercise in the circumstances.

(3) An investment fund may indemnify a person or company providing services to it against legal fees, judgments and amounts paid in settlement, actually and reasonably incurred by that person or company in connection with services provided by that person or company to the investment fund, if

(a) those fees, judgments and amounts were not incurred as a result of a breach of the standard of care described in subsection (1) or (2); and

(b) the investment fund has reasonable grounds to believe that the action or inaction that caused the payment of the fees, judgments and amounts paid in settlement was in the best interests of the investment fund.

(4) An investment fund must not incur the cost of any portion of liability insurance that insures a person or company for a liability except to the extent that the person or company may be indemnified for that liability under this section.

(5) This section does not apply to any losses to an investment fund or securityholder arising out of an action or inaction by any of the following:

(a) a director of the investment fund;

(b) a custodian or sub-custodian of the investment fund, except as set out in subsection (6).

(6) This section applies to any losses to an investment fund or securityholder arising out of an action or inaction by a custodian or sub-custodian acting as agent of the investment fund in administering the securities lending, repurchase or reverse repurchase transactions of the investment fund.

PART 5 FUNDAMENTAL CHANGES

5.1 Matters Requiring Securityholder Approval – (1) The prior approval of the securityholders of an investment fund, given as provided in section 5.2, is required before the occurrence of each of the following:

(a) the basis of the calculation of a fee or expense that is charged to the investment fund or directly to its securityholders by the investment fund or its manager in connection with the holding of securities of the investment fund is changed in a way that could result in an increase in charges to the investment fund or to its securityholders;

(a.1) a fee or expense, to be charged to the investment fund or directly to its securityholders by the investment fund or its manager in connection with the holding of securities of the investment fund that could result in an increase in charges to the investment fund or to its securityholders, is introduced;

(b) the manager of the investment fund is changed, unless the new manager is an affiliate of the current manager;

(c) the fundamental investment objectives of the investment fund are changed;

(d) [Repealed]

(e) the investment fund decreases the frequency of the calculation of its net asset value per security;

(f) the investment fund undertakes a reorganization with, or transfers its assets to, another issuer, if

(i) the investment fund ceases to continue after the reorganization or transfer of assets, and

(ii) the transaction results in the securityholders of the investment fund becoming securityholders in the other issuer;

(g) the investment fund undertakes a reorganization with, or acquires assets from, another issuer, if

(i) the investment fund continues after the reorganization or acquisition of assets,

(ii) the transaction results in the securityholders of the other issuer becoming securityholders in the investment fund, and

(iii) the transaction would be a material change to the investment fund;

(h) the investment fund implements any of the following:

(i) in the case of a non-redeemable investment fund, a restructuring into a mutual fund;

(ii) in the case of a mutual fund, a restructuring into a non-redeemable investment fund;

(iii) a restructuring into an issuer that is not an investment fund.

(2) An investment fund must not bear any of the costs or expenses associated with a restructuring referred to in paragraph (1)(h).

5.2 Approval of Securityholders – (1) Unless a greater majority is required by the constating documents of the investment fund, the laws applicable to the investment fund or an applicable agreement, the approval of the securityholders of the investment fund to a matter referred to in subsection 5.1(1) must be given by a resolution passed by at least a majority of the votes cast at a meeting of the securityholders of the investment fund duly called and held to consider the matter.

(2) Despite subsection (1), the holders of securities of a class or series of a class of securities of an investment fund must vote separately as a class or series of a class on a matter referred to in subsection 5.1(1) if that class or series of a class is affected by the action referred to in subsection 5.1(1) in a manner different from holders of securities of other classes or series of a class.

(3) Despite subsection 5.1(1) and subsections (1) and (2), if the constating documents of the investment fund so provide, the holders of securities of a class or series of a class of securities of an investment fund must not be entitled to vote on a matter referred to in subsection 5.1(1) if they, as holders of the class or series of a class, are not affected by the action referred to in subsection 5.1(1).

5.3 Circumstances in Which Approval of Securityholders Not Required – (1) Despite subsection 5.1(1), the approval of securityholders of an investment fund is not required to be obtained for a change referred to in paragraphs 5.1(1)(a) and (a.1)

(a) if

(i) the investment fund is at arm's length to the person or company charging the fee or expense to the investment fund referred to in paragraphs 5.1(1)(a) and (a.1),

(ii) the prospectus of the investment fund discloses that, although the approval of securityholders will not be obtained before making the changes, securityholders will be sent a written notice at least 60 days before the effective date of the change that is to be made that could result in an increase in charges to the investment fund, and

(iii) the notice referred to in subparagraph (ii) is actually sent at least 60 days before the effective date of the change; or

(b) if, in the case of a mutual fund,

(i) the mutual fund is permitted by this Instrument to be described as a "no-load" fund,

(ii) the prospectus of the mutual fund discloses that securityholders will be sent a written notice at least 60 days before the effective date of a change that is to be made that could result in an increase in charges to the mutual fund, and

(iii) the notice referred to in subparagraph (ii) is actually sent at least 60 days before the effective date of the change.

(2) Despite subsection 5.1(1), the approval of securityholders of an investment fund is not required to be obtained for a change referred to in paragraph 5.1(1)(f) if either of the following paragraphs apply:

(a) all of the following apply:

(i) the independent review committee of the investment fund has approved the change under subsection 5.2(2) of NI 81-107;

(ii) the investment fund is being reorganized with, or its assets are being transferred to, another investment fund to which this Instrument and NI 81-107 apply and that is managed by the manager, or an affiliate of the manager, of the investment fund;

(iii) the reorganization or transfer of assets of the investment fund complies with the criteria in paragraphs 5.6(1)(a), (b), (c), (d), (g), (h), (i), (j) and (k);

(iv) the prospectus of the investment fund discloses that, although the approval of securityholders may not be obtained before making the change, securityholders will be sent a written notice at least 60 days before the effective date of the change;

(v) the notice referred to in subparagraph (iv) to securityholders is sent at least 60 days before the effective date of the change;

(b) all of the following apply:

(i) the investment fund is a non-redeemable investment fund that is being reorganized with, or its assets are being transferred to, a mutual fund that is

(A) a mutual fund to which this Instrument and NI 81-107 apply,

(B) managed by the manager, or an affiliate of the manager, of the investment fund,

(C) not in default of any requirement of securities legislation, and

(D) a reporting issuer in the local jurisdiction and the mutual fund has a current prospectus in the local jurisdiction;

(ii) the transaction is a tax-deferred transaction under subsection 85(1) of the ITA;

(iii) the securities of the investment fund do not give securityholders of the investment fund the right to request that the investment fund redeem the securities;

(iv) since its inception, there has been no market through which securityholders of the investment fund could sell securities of the investment fund;

(v) every prospectus of the investment fund discloses that

(A) securityholders of the investment fund, other than the manager, promoter or an affiliate of the manager or promoter, will cease to be securityholders of the investment fund within 30 months following the completion of the initial public offering by the investment fund, and

(B) the investment fund will, within 30 months following the completion of the initial public offering of the investment fund, undertake a reorganization with, or transfer its assets to, a mutual fund that is managed by the manager of the investment fund or by an affiliate of the manager of the investment fund;

(vi) the mutual fund bears none of the costs and expenses associated with the transaction;

(vii) the reorganization or transfer of assets of the investment fund complies with subparagraphs 5.3(2)(a)(i), (iv) and (v) and paragraphs 5.6(1)(d) and (k).

5.3.1 Change of Auditor of an Investment Fund – The auditor of an investment fund must not be changed unless

(a) the independent review committee of the investment fund has approved the change of auditor under subsection 5.2(2) of NI 81-107;

(b) the prospectus of the investment fund discloses that, although the approval of securityholders will not be obtained before making the change, securityholders will be sent a written notice at least 60 days before the effective date of the change, and

(c) the notice referred to in paragraph (b) to securityholders is sent 60 days before the effective date of the change.

5.4 Formalities Concerning Meetings of Securityholders – (1) A meeting of securityholders of an investment fund called to consider any matter referred to in subsection 5.1(1) must be called on written notice sent at least 21 days before the date of the meeting.

(2) The notice referred to in subsection (1) must contain or be accompanied by a statement that includes

(a) a description of the change or transaction proposed to be made or entered into and, if the matter is one referred to in paragraphs 5.1(1)(a) or (a.1), the effect that the change would have had on the management expense ratio of the investment fund had the change been in force throughout the investment fund's last completed financial year;

(b) the date of the proposed implementation of the change or transaction; and

(c) all other information and documents necessary to comply with the applicable proxy solicitation requirements of securities legislation for the meeting.

5.5 Approval of Securities Regulatory Authority – (1) The approval of the securities regulatory authority or regulator is required before

(a) the manager of an investment fund is changed, unless the new manager is an affiliate of the current manager;

(a.1) a change of control of the manager of an investment fund occurs;

(b) a reorganization or transfer of assets of an investment fund is implemented, if the transaction will result in the securityholders of the investment fund becoming securityholders in another issuer;

(c) a change of the custodian of an investment fund is implemented, if there has been or will be, in connection with the proposed change, a change of the type referred to in paragraph (a); or

(d) an investment fund suspends, other than under section 10.6, the rights of securityholders to request that the investment fund redeem their securities.

(2) [Repealed]

(3) Despite subsection (1), in Ontario only the regulator may grant an approval referred to in subsection (1).

5.6 Pre-Approved Reorganizations and Transfers – (1) Despite subsection 5.5(1), the approval of the securities regulatory authority or regulator is not required to implement a transaction referred to in paragraph 5.5(1)(b) if all of the following paragraphs apply:

(a) the investment fund is being reorganized with, or its assets are being transferred to, another investment fund to which this Instrument applies and that

(i) is managed by the manager, or an affiliate of the manager, of the investment fund,

(ii) a reasonable person would consider to have substantially similar fundamental investment objectives, valuation procedures and fee structure as the investment fund,

(iii) is not in default of any requirement of securities legislation, and

(iv) is a reporting issuer in the local jurisdiction and, if it is a mutual fund, also has a current prospectus in the local jurisdiction;

(b) the transaction is a "qualifying exchange" within the meaning of section 132.2 of the ITA or is a tax-deferred transaction under subsection 85(1), 85.1(1), 86(1) or 87(1) of the ITA;

(c) the transaction contemplates the wind-up of the investment fund as soon as reasonably possible following the transaction;

(d) the portfolio assets of the investment fund to be acquired by the other investment fund as part of the transaction

(i) may be acquired by the other investment fund in compliance with this Instrument, and

(ii) are acceptable to the portfolio adviser of the other investment fund and consistent with the other investment fund's fundamental investment objectives;

(e) the transaction is approved

(i) by the securityholders of the investment fund in accordance with paragraph 5.1(1)(f), unless subsection 5.3(2) applies, and

(ii) if required, by the securityholders of the other investment fund in accordance with paragraph 5.1(1)(g);

(f) the materials sent to securityholders of the investment fund in connection with the approval under paragraph 5.1(1)(f) include

(i) a circular that, in addition to other requirements prescribed by law, describes the proposed transaction, the investment fund into which the investment fund will be reorganized, the income tax considerations for the investment funds participating in the transaction and their securityholders, and, if the investment fund is a corporation and the transaction involves its shareholders becoming securityholders of an investment fund that is established as a trust, a description of the material differences between being a shareholder of a corporation and being a securityholder of a trust,

(ii) if the other investment fund is a mutual fund, the most recently filed fund facts document for the other investment fund, and

(iii) a statement that securityholders may, in respect of the reorganized investment fund,

(A) obtain all of the following documents at no cost by contacting the reorganized investment fund at an address or telephone number specified in the statement:

(I) if the reorganized investment fund is a mutual fund, the current prospectus;

(II) the most recently filed annual information form, if one has been filed;

(III) as applicable, the most recently filed fund facts document;

(IV) the most recently filed annual financial statements and interim financial reports;

(V) the most recently filed annual and interim management reports of fund performance, or

(B) access those documents at a website address specified in the statement;

(g) the investment fund has complied with Part 11 of National Instrument 81-106 Investment Fund Continuous Disclosure in connection with the making of the decision to proceed with the transaction by the board of directors of the manager of the investment fund or of the investment fund;

(h) the investment funds participating in the transaction bear none of the costs and expenses associated with the transaction;

(i) if the investment fund is a mutual fund, securityholders of the investment fund continue to have the right to redeem securities of the investment fund up to the close of business on the business day immediately before the effective date of the transaction;

(j) if the investment fund is a non-redeemable investment fund, all of the following apply:

(i) the investment fund issues and files a news release that discloses the transaction;

(ii) securityholders of the investment fund may redeem securities of the investment fund at a date that is after the date of the news release referred to in subparagraph (i) and before the effective date of the transaction;

(iii) the securities submitted for redemption in accordance with subparagraph (ii) are redeemed at a price equal to their net asset value per security on the redemption date;

(k) the consideration offered to securityholders of the investment fund for the transaction has a value that is equal to the net asset value of the investment fund calculated on the date of the transaction.

(1.1) Despite subsection 5.5(1), the approval of the securities regulatory authority or regulator is not required to implement a transaction referred to in paragraph 5.5(1)(b) if all the conditions in paragraph 5.3(2)(b) are satisfied and the independent review committee of the mutual fund involved in the transaction has approved the transaction in accordance with subsection 5.2(2) of NI 81-107.

(2) An investment fund that has continued after a transaction described in paragraph 5.5(1)(b) must, if the audit report accompanying its audited financial statements for its first completed financial year after the transaction contains a modified opinion in respect of the value of the portfolio assets acquired by the investment fund in the transaction, send a copy of those financial statements to each person or company that was a securityholder of an investment fund that was terminated as a result of the transaction and that is not a securityholder of the investment fund.

5.7 Applications – (1) An application for an approval required under section 5.5 must contain,

(a) if the application is required by paragraph 5.5(1)(a) or (a.1),

(i) details of the proposed transaction,

(ii) details of the proposed new manager or the person or company proposing to acquire control of the manager,

(iii) as applicable, the names, residence addresses and birthdates of

(A) all proposed new partners, directors or officers of the manager,

(B) all partners, directors or officers of the person or company proposing to acquire control of the manager,

(C) any proposed new individual trustee of the investment fund, and

(D) any new directors or officers of the investment fund,

(iv) all information necessary to permit the securities regulatory authority or regulator to conduct security checks on the individuals referred to in subparagraph (iii),

(v) sufficient information to establish the integrity and experience of the persons or companies referred to in subparagraphs (ii) and (iii), and

(vi) details of how the proposed transaction will affect the management and administration of the investment fund;

(b) if the application is required by paragraph 5.5(1)(b),

(i) details of the proposed transaction,

(ii) details of the total annual returns of the investment fund and, if the other issuer is an investment fund, the other issuer for each of the previous five years,

(iii) a description of the differences between, as applicable, the fundamental investment objectives, investment strategies, valuation procedures and fee structure of the investment fund and the other issuer and any other material differences between the investment fund and the other issuer, and

(iv) a description of those elements of the proposed transaction that make section 5.6 inapplicable;

(c) if the application is required by paragraph 5.5(1)(c), sufficient information to establish that the proposed custodial arrangements will be in compliance with Part 6;

(d) if the application relates to a matter that would constitute a material change for the investment fund, a draft amendment to the prospectus and, if applicable, to the fund facts document of the investment fund reflecting the change; and

(e) if the matter is one that requires the approval of securityholders, confirmation that the approval has been obtained or will be obtained before the change is implemented.

(2) An investment fund that applies for an approval under paragraph 5.5(1)(d) must

(a) make that application to the securities regulatory authority or regulator in the jurisdiction in which the head office or registered office of the investment fund is situated; and

(b) concurrently file a copy of the application so made with the securities regulatory authority or the regulator in the local jurisdiction if the head office or registered office of the investment fund is not situated in the local jurisdiction.

(3) An investment fund that has complied with subsection (2) in the local jurisdiction may suspend the right of securityholders to request that the investment fund redeem their securities if

(a) the securities regulatory authority or regulator in the jurisdiction in which the head office or registered office of the investment fund is situated has granted approval to the application made under paragraph (2)(a); and

(b) the securities regulatory authority or regulator in the local jurisdiction has not notified the investment fund, by the close of business on the business day immediately following the day on which the copy of the application referred to in paragraph (2)(b) was received, either that

(i) the securities regulatory authority or regulator has refused to grant approval to the application, or

(ii) this subsection may not be relied upon by the investment fund in the local jurisdiction.

5.8 Matters Requiring Notice – (1) A person or company must not continue to act as manager of an investment fund following a direct or indirect change of control of the person or company unless

(a) notice of the change of control was given to all securityholders of the investment fund at least 60 days before the change; and

(b) the notice referred to in paragraph (a) contains the information that would be required by law to be provided to securityholders if securityholder approval of the change were required to be obtained.

(2) A mutual fund must not terminate unless notice of the termination is given to all securityholders of the mutual fund at least 60 days before termination.

(3) The manager of a mutual fund that has terminated must give notice of the termination to the securities regulatory authority within 30 days of the termination.

5.8.1 Termination of a Non-Redeemable Investment Fund – (1) A non-redeemable investment fund must not terminate unless the investment fund first issues and files a news release that discloses the termination.

(2) A non-redeemable investment fund must not terminate earlier than 15 days or later than 90 days after the filing of the news release under subsection (1).

(3) Subsections (1) and (2) do not apply in respect of a transaction referred to in paragraph 5.1(1)(f).

5.9 Relief from Certain Regulatory Requirements – (1) The investment fund conflict of interest investment restrictions and the investment fund conflict of interest reporting requirements do not apply to a transaction referred to in paragraph 5.5(1)(b) if the approval of the securities regulatory authority or regulator has been given to the transaction.

(2) The investment fund conflict of interest investment restrictions and the investment fund conflict of interest reporting requirements do not apply to a transaction described in section 5.6.

5.10 [Repealed]

PART 6 CUSTODIANSHIP OF PORTFOLIO ASSETS

6.1 General – (1) Except as provided in sections 6.8, 6.8.1 and 6.9, all portfolio assets of an investment fund must be held under the custodianship of one custodian that satisfies the requirements of section 6.2.

(2) Except as provided in subsection 6.5(3) and sections 6.8, 6.8.1 and 6.9, portfolio assets of an investment fund must be held

(a) in Canada by the custodian or a sub-custodian of the investment fund; or

(b) outside Canada by the custodian or a sub-custodian of the investment fund, if appropriate to facilitate portfolio transactions of the investment fund outside Canada.

(3) The custodian or a sub-custodian of an investment fund may appoint one or more sub-custodians to hold portfolio assets of the investment fund, if

(a) in the case of an appointment by the custodian, the investment fund consents in writing to the appointment,

(a.1) in the case of an appointment by a sub-custodian, the investment fund and the custodian of the investment fund consent in writing to the appointment,

(b) the sub-custodian that is to be appointed is an entity described in section 6.2 or 6.3, as applicable,

(c) the arrangements under which a sub-custodian is appointed are such that the investment fund may enforce rights directly, or require the custodian or a sub-custodian to enforce rights on behalf of the investment fund, to the portfolio assets held by the appointed sub-custodian, and

(d) the appointment is otherwise in compliance with this Instrument.

(4) The written consent referred to in paragraphs (3)(a) and (a.1) may be in the form of a general consent, contained in the agreement governing the relationship between the investment fund and the custodian, or the custodian and the sub-custodian, to the appointment of entities that are part of an international network of sub-custodians within the organization of the appointed custodian or sub-custodian.

(5) A custodian or sub-custodian must provide to the investment fund a list of all entities that are appointed sub-custodians under a general consent referred to in subsection (4).

(6) Despite any other provisions of this Part, the manager of an investment fund must not act as custodian or sub-custodian of the investment fund.

6.2 Entities Qualified to Act as Custodian or Sub-Custodian for Assets Held in Canada – If portfolio assets are held in Canada by a custodian or sub-custodian, the custodian or sub-custodian must be one of the following:

1. a bank listed in Schedule I, II or III of the Bank Act (Canada);

2. a trust company that is incorporated under the laws of Canada or a jurisdiction and licensed or registered under the laws of Canada or a jurisdiction, and that has equity, as reported in its most recent audited financial statements, of not less than $10,000,000;

3. a company that is incorporated under the laws of Canada or of a jurisdiction, and that is an affiliate of a bank or trust company referred to in paragraph 1 or 2, if either of the following applies:

   (a) the company has equity, as reported in its most recent audited financial statements that have been made public, of not less than $10,000,000;

   (b) the bank or trust company has assumed responsibility for all of the custodial obligations of the company for that investment fund.

6.3 Entities Qualified to Act as Sub-Custodian for Assets Held outside Canada – If portfolio assets are held outside of Canada by a sub-custodian, the sub-custodian must be one of the following:

1. an entity referred to in section 6.2;

2. an entity that

   (a) is incorporated or organized under the laws of a country, or a political subdivision of a country, other than Canada,

   (b) is regulated as a banking institution or trust company by the government, or an agency of the government, of the country under the laws of which it is incorporated or organized, or a political subdivision of that country, and

(c) has equity, as reported in its most recent audited financial statements, of not less than the equivalent of $100,000,000;

3. an affiliate of an entity referred to in paragraph 1 or 2 if either of the following applies:

(a) the affiliate has equity, as reported in its most recent audited financial statements that have been made public, of not less than the equivalent of $100,000,000;

(b) the entity referred to in paragraph 1 or 2 has assumed responsibility for all of the custodial obligations of the affiliate for that investment fund.

6.4 Contents of Custodian and Sub-Custodian Agreements – (1) All custodian agreements and sub-custodian agreements of an investment fund must provide for

(a) the location of portfolio assets,

(b) any appointment of a sub-custodian,

(c) requirements concerning lists of sub-custodians,

(d) the method of holding portfolio assets,

(e) the standard of care and responsibility for loss, and

(f) requirements concerning review and compliance reports.

(2) A sub-custodian agreement concerning the portfolio assets of an investment fund must provide for the safekeeping of portfolio assets on terms consistent with the custodian agreement of the investment fund.

(2.1) An agreement referred to under subsections (1) and (2) must comply with the requirements of this Part.

(3) A custodian agreement or sub-custodian agreement concerning the portfolio assets of an investment fund must not

(a) provide for the creation of any security interest on the portfolio assets of the investment fund except for a good faith claim for payment of the fees and expenses of the custodian or a sub-custodian for acting in that capacity or to secure the obligations of the investment fund to repay borrowings by the investment fund from the custodian or a sub-custodian for the purpose of settling portfolio transactions; or

(b) contain a provision that would require the payment of a fee to the custodian or a sub-custodian for the transfer of the beneficial ownership of portfolio assets of the investment fund, other than for safekeeping and administrative services in connection with acting as custodian or sub-custodian.

6.5 Holding of Portfolio Assets and Payment of Fees – (1) Except as provided in subsections (2) and (3) and sections 6.8, 6.8.1 and 6.9, portfolio assets of an investment fund not registered in the name of the investment fund must be registered in the name of the custodian or a sub-custodian of the investment fund, or any of their respective nominees, with an account number or other designation in the records of the custodian sufficient to show that the beneficial ownership of the portfolio assets is vested in the investment fund.

(2) The custodian or a sub-custodian of an investment fund, or an applicable nominee, must segregate portfolio assets issued in bearer form to show that the beneficial ownership of the property is vested in the investment fund.

(3) The custodian or a sub-custodian of an investment fund may deposit portfolio assets of the investment fund with a depository, or a clearing agency, that operates a book-based system.

(4) The custodian or a sub-custodian of an investment fund arranging for the deposit of portfolio assets of the investment fund with, and their delivery to, a depository, or clearing agency, that operates a book-based system must ensure that the records of any of the applicable participants in that book-based system or of the custodian contain an account number or other designation sufficient to show that the beneficial ownership of the portfolio assets is vested in the investment fund.

(5) An investment fund must not pay a fee to the custodian or a sub-custodian of the investment fund for the transfer of beneficial ownership of portfolio assets of the investment fund other than for safekeeping and administrative services in connection with acting as custodian or sub-custodian.

6.6 Standard of Care – (1) The custodian and each sub-custodian of an investment fund, in carrying out their duties concerning the safekeeping of, and dealing with, the portfolio assets of the investment fund, must exercise

(a) the degree of care, diligence and skill that a reasonably prudent person would exercise in the circumstances; or

(b) at least the same degree of care as they exercise with respect to their own property of a similar kind, if this is a higher degree of care than the degree of care referred to in paragraph (a).

(2) An investment fund must not relieve the custodian or a sub-custodian of the investment fund from liability to the investment fund or to a securityholder of the investment fund for loss that arises out of the failure of the custodian or sub-custodian to exercise the standard of care imposed by subsection (1).

(3) An investment fund may indemnify the custodian or a sub-custodian against legal fees, judgments and amounts paid in settlement, actually and reasonably incurred by that entity in connection with custodial or sub-custodial services provided by that entity to the investment fund, if those fees, judgments and amounts were not incurred as a result of a breach of the standard of care imposed by subsection (1).

(4) An investment fund must not incur the cost of any portion of liability insurance that insures the custodian or a sub-custodian for a liability, except to the extent that the custodian or sub-custodian may be indemnified for that liability under this section.

6.7 Review and Compliance Reports – (1) The custodian of an investment fund must, on a periodic basis not less frequently than annually,

(a) review the custodian agreement and all sub-custodian agreements of the investment fund to determine if those agreements are in compliance with this Part;

(b) make reasonable enquiries as to whether each sub-custodian satisfies the applicable requirements of section 6.2 or 6.3; and

(c) make or cause to be made any changes that may be necessary to ensure that

(i) the custodian and sub-custodian agreements are in compliance with this Part; and

(ii) all sub-custodians of the investment fund satisfy the applicable requirements of section 6.2 or6.3.

(2) The custodian of an investment fund must, within 60 days after the end of each financial year of the investment fund, advise the investment fund in writing

(a) of the names and addresses of all sub-custodians of the investment fund;

(b) whether the custodian and sub-custodian agreements are in compliance with this Part; and

(c) whether, to the best of the knowledge and belief of the custodian, each sub-custodian satisfies section 6.2 or 6.3, as applicable.

(3) A copy of the report referred to in subsection (2) must be delivered by or on behalf of the investment fund to the securities regulatory authority within 30 days after the filing of the annual financial statements of the investment fund.

6.8 Custodial Provisions relating to Borrowing, Derivatives and Securities Lending, Repurchase and Reverse Repurchase Agreements – (1) An investment fund may deposit portfolio assets as margin for transactions in Canada involving ~~clearing corporation options, options on futures or standardized futures~~cleared specified derivatives with a dealer that is a member of an SRO that is a participating member of CIPF if the amount of margin deposited does not, when aggregated with the amount of margin already held by the dealer on behalf of the investment fund, exceed 10 ~~percent~~% of the net asset value of the investment fund as at the time of deposit.

(2) An investment fund may deposit portfolio assets with a dealer as margin for transactions outside Canada involving ~~clearing corporation options, options on futures or standardized futures~~cleared specified derivatives if

(a) ~~in the case of standardized futures and options on futures,~~ the dealer is a member of a futures exchange or~~, in the case of clearing corporation options,~~ is a member of a stock exchange, and, as a result in either case, is subject to a regulatory audit;

(b) the dealer has a net worth, determined from its most recent audited financial statements that have been made public, in excess of the equivalent of $50 million; and

(c) the amount of margin deposited does not, when aggregated with the amount of margin already held by the dealer on behalf of the investment fund, exceed 10 ~~percent~~% of the net asset value of the investment fund as at the time of deposit.

(3) An investment fund may deposit with its counterparty portfolio assets over which it has granted a security interest in connection with a particular specified derivatives transaction.

(3.1) An investment fund may deposit with its lender, portfolio assets over which it has granted a security interest in connection with a borrowing agreement entered into pursuant to section 2.6.

(4) The agreement by which portfolio assets are deposited in accordance with subsection (1), (2) ~~or~~, (3) or (3.1) must require the person or company holding the portfolio assets to ensure that its records show that the investment fund is the beneficial owner of the portfolio assets.

(5) An investment fund may deliver portfolio assets to a person or company in satisfaction of its obligations under a borrowing, securities lending, repurchase or reverse purchase agreement that complies with this Instrument if the collateral, cash proceeds or purchased securities that are delivered to the investment fund in connection with the transaction are held under the custodianship of the custodian or a sub-custodian of the investment fund in compliance with this Part.

6.8.1 Custodial Provisions relating to Short Sales – (1) Except where the borrowing agent is the investment fund's custodian or sub-custodian, if an investment fund deposits portfolio assets with a borrowing agent as security in connection with a short sale of securities, the market value of portfolio assets deposited with the borrowing agent must not, when aggregated with the market value of portfolio assets already held by the borrowing agent as security for outstanding short sales of securities by the investment fund, exceed 10% of the net asset value of the investment fund at the time of deposit.

(2) An investment fund must not deposit portfolio assets as security in connection with a short sale of securities with a dealer in Canada unless the dealer is a registered dealer and is a member of IIROC.

(3) An investment fund must not deposit portfolio assets as security in connection with a short sale of securities with a dealer outside of Canada unless that dealer

(a) is a member of a stock exchange and is subject to a regulatory audit; and

(b) has a net worth, determined from its most recent audited financial statements that have been made public, in excess of the equivalent of $50 million.

6.9 Separate Account for Paying Expenses – An investment fund may deposit cash in Canada with an entity referred to in paragraph 1 or 2 of section 6.2 to facilitate the payment of regular operating expenses of the investment fund.

PART 7 INCENTIVE FEES

7.1 Incentive Fees – (1) A mutual fund other than an alternative fund must not pay, or enter into arrangements that would require it to pay, and securities of a mutual fund must not be sold on the basis that an investor would be required to pay, a fee that is determined by the performance of the mutual fund, unless

(a) the fee is calculated with reference to a benchmark or index that

(i) reflects the market sectors in which the mutual fund invests according to its fundamental investment objectives,

(ii) is available to persons or companies other than the mutual fund and persons providing services to it, and

(iii) is a total return benchmark or index;

(b) the payment of the fee is based upon a comparison of the cumulative total return of the mutual fund against the cumulative total percentage increase or decrease of the benchmark or index for the period that began immediately after the last period for which the performance fee was paid; and

(c) the method of calculation of the fee and details of the composition of the benchmark or index are described in the prospectus of the mutual fund.

(2) An alternative fund must not pay, or enter into arrangements that would require it to pay, and securities of an alternative fund must not be sold on the basis that an investor would be required to pay, a fee that is determined by the performance of the alternative fund unless

(a) the payment of the fee is based on the cumulative total return of the alternative fund for the period that began immediately after the last period for which the performance fee was paid; and

(b) the method of calculating the fee is described in the alternative fund's prospectus.

7.2 Multiple Portfolio Advisers - Section 7.1 applies to fees payable to a portfolio adviser of a mutual fund that has more than one portfolio adviser, if the fees are calculated on the basis of the performance of the portfolio assets under management by that portfolio adviser, as if those portfolio assets were a separate mutual fund.

PART 8 CONTRACTUAL PLANS

8.1 Contractual Plans – A person or company must not sell securities of a mutual fund by way of a contractual plan unless

(a) the contractual plan was established, and its terms described in a prospectus that was filed with the securities regulatory authority, before the date that this Instrument came into force;

(b) there have been no changes made to the contractual plan or the rights of securityholders under the contractual plan since the date that this Instrument came into force; and

(c) the contractual plan has continued to be operated in the same manner after the date that this Instrument came into force as it was on that date.

PART 9 SALE OF SECURITIES OF AN INVESTMENT FUND

9.0.1 Application – This Part, other than subsection 9.3(2), does not apply to an exchange-traded mutual fund that is not in continuous distribution.

9.1 Transmission and Receipt of Purchase Orders – (0.1) This section does not apply to an exchange-traded mutual fund.

(1) Each purchase order for securities of a mutual fund received by a participating dealer at a location that is not its principal office must, on the day the order is received, be sent by same day or next day courier, same day or next day priority post, telephone or electronic means, without charge to the person or company placing the order or to the mutual fund, to the principal office of the participating dealer or a person or company providing services to the participating dealer.

(2) Each purchase order for securities of a mutual fund received by a participating dealer at its principal office, a person or company providing services to the participating dealer, or by the principal distributor of the mutual fund at a location that is not an order receipt office of the mutual fund must, on the day the order is received, be sent by same day or next day courier, same day or next day priority post, telephone or electronic means, without charge to the person or company placing the order or to the mutual fund, to an order receipt office of the mutual fund.

(3) Despite subsections (1) and (2), a purchase order for securities of a mutual fund received at a location referred to in those subsections after normal business hours on a business day, or on a day that is not a business day, may be sent, in the manner and to the place required by those subsections, on the next business day.

(4) A participating dealer, a principal distributor or a person or company providing services to the participating dealer or principal distributor, that sends purchase orders electronically may

(a) specify a time on a business day by which a purchase order must be received in order that it be sent electronically on that business day; and

(b) despite subsections (1) and (2), send electronically on the next business day a purchase order received after the time specified under paragraph (a).

(5) A mutual fund is deemed to have received a purchase order for securities of the mutual fund when the order is received at an order receipt office of the mutual fund.

(6) Despite subsection (5), a mutual fund may provide that a purchase order for securities of the mutual fund received at an order receipt office of the mutual fund after a specified time on a business day, or on a day that is not a business day, will be considered to be received by the mutual fund on the next business day following the day of actual receipt.

(7) A principal distributor or participating dealer must ensure that a copy of each purchase order received in a jurisdiction is sent, by the time it is sent to the order receipt office of the mutual fund under subsection (2), to a person responsible for the supervision of trades made on behalf of clients for the principal distributor or participating dealer in the jurisdiction.

9.2 Acceptance of Purchase Orders – A mutual fund may reject a purchase order for the purchase of securities of the mutual fund if

(a) the rejection of the order is made no later than one business day after receipt by the mutual fund of the order;

(b) on rejection of the order, all cash received with the order is refunded immediately; and

(c) the prospectus of the mutual fund states that the right to reject a purchase order for securities of the mutual fund is reserved and reflects the requirements of paragraphs (a) and (b).

9.3 Issue Price of Securities – (1) The issue price of a security of a mutual fund to which a purchase order pertains must be the net asset value per security of that class, or series of a class, next determined after the receipt by the mutual fund of the order.

(2) The issue price of a security of an exchange-traded mutual fund that is not in continuous distribution, or of a non-redeemable investment fund, must not,

(a) as far as reasonably practicable, be a price that causes dilution of the net asset value of other outstanding securities of the investment fund at the time the security is issued, and

(b) be a price that is less than the most recent net asset value per security of that class, or series of a class, calculated prior to the pricing of the offering.

9.4 Delivery of Funds and Settlement – (1) A principal distributor, a participating dealer, or a person or company providing services to the principal distributor or participating dealer must forward any cash or securities received for payment of the issue price of securities of a mutual fund to an order receipt office of the mutual fund so that the cash or securities arrive at the order receipt office as soon as practicable and in any event no later than the third business day after the pricing date.

(2) Payment of the issue price of securities of a mutual fund must be made to the mutual fund on or before the third business day after the pricing date for the securities by using any or a combination of the following methods of payment:

(a) by paying cash in a currency in which the net asset value per security of the mutual fund is calculated;

(b) by making good delivery of securities if

(i) the mutual fund would at the time of payment be permitted to purchase those securities,

(ii) the securities are acceptable to the portfolio adviser of the mutual fund and consistent with the mutual fund's investment objectives, and

(iii) the value of the securities is at least equal to the issue price of the securities of the mutual fund for which they are payment, valued as if the securities were portfolio assets of the mutual fund.

(3) [Repealed]

(4) If payment of the issue price of the securities of a mutual fund to which a purchase order pertains is not made on or before the third business day after the pricing date or if the mutual fund has been paid the issue price by a cheque or method of payment that is subsequently not honoured,

(a) the mutual fund must redeem the securities to which the purchase order pertains as if it had received an order for the redemption of the securities on the fourth business day after the pricing date or on the day on which the mutual fund first knows that the method of payment will not be honoured; and

(b) the amount of the redemption proceeds derived from the redemption must be applied to reduce the amount owing to the mutual fund on the purchase of the securities and any banking costs incurred by the mutual fund in connection with the dishonoured cheque.

(5) If the amount of the redemption proceeds referred to in subsection (4) exceeds the aggregate of issue price of the securities and any banking costs incurred by the mutual fund in connection with the dishonoured cheque, the difference must belong to the mutual fund.

(6) If the amount of the redemption proceeds referred to in subsection (4) is less than the issue price of the securities and any banking costs incurred by the mutual fund in connection with the dishonoured cheque,

(a) if the mutual fund has a principal distributor, the principal distributor must pay, immediately upon notification by the mutual fund, to the mutual fund the amount of the deficiency; or

(b) if the mutual fund does not have a principal distributor, the participating dealer that delivered the relevant purchase order to the mutual fund must pay immediately, upon notification by the mutual fund, to the mutual fund the amount of the deficiency.

PART 9.1 WARRANTS AND SPECIFIED DERIVATIVES

9.1.1 Issuance of Warrants or Specified Derivatives – An investment fund must not

(a) issue a conventional warrant or right, or

(b) enter into a short position in a specified derivative the underlying interest of which is a security of the investment fund.

PART 10 REDEMPTION OF SECURITIES OF AN INVESTMENT FUND

10.1 Requirements for Redemptions – (1) An investment fund must not pay redemption proceeds unless

(a) if the security of the investment fund to be redeemed is represented by a certificate, the investment fund has received the certificate or appropriate indemnities in connection with a lost certificate; and

(b) either

(i) the investment fund has received a written redemption order, duly completed and executed by or on behalf of the securityholder, or

(ii) the investment fund permits the making of redemption orders by telephone or electronic means by, or on behalf of, a securityholder who has made prior arrangements with the investment fund in that regard and the relevant redemption order is made in compliance with those arrangements.

(2) An investment fund may establish reasonable requirements applicable to securityholders who wish to have the investment fund redeem securities, not contrary to this Instrument, as to procedures to be followed and documents to be delivered by the following times:

(a) in the case of a mutual fund, other than an exchange-traded mutual fund that is not in continuous distribution, by the time of delivery of a redemption order to an order receipt office of the mutual fund;

(a.1) in the case of an exchange-traded mutual fund that is not in continuous distribution or of a non-redeemable investment fund, by the time of delivery of a redemption order;

(b) by the time of payment of redemption proceeds.

(2.1) If disclosed in the prospectus, an alternative fund may include, as part of the requirements established in subsection (2), a provision that securityholders of the alternative fund will not have the right to redeem their securities for a period of up to 6 months after the date on which the receipt is issued for the initial prospectus of the alternative fund.

(3) A manager of an investment fund must provide to securityholders of the investment fund at least annually a statement containing the following:

(a) a description of the requirements referred to in subsection (1);

(b) a description of the requirements established by the investment fund under subsection (2);

(c) a detailed reference to all documentation required for redemption of securities of the investment fund;

(d) detailed instructions on the manner in which documentation is to be delivered to participating dealers, the investment fund or a person or company providing services to the investment fund to which a redemption order may be made;

(e) a description of all other procedural or communication requirements;

(f) an explanation of the consequences of failing to meet timing requirements.

(4) The statement referred to in subsection (3) is not required to be separately provided, in any year, if the requirements are described in any document that is sent to all securityholders in that year.

10.2 Transmission and Receipt of Redemption Orders – (0.1) This section does not apply to an exchange-traded mutual fund.

(1) Each redemption order for securities of a mutual fund received by a participating dealer at a location that is not its principal office must, on the day the order is received, be sent by same day or next day courier, same day or next day priority post, telephone or electronic means, without charge to the relevant securityholder or to the mutual fund, to the principal office of the participating dealer or a person or company providing services to the participating dealer.

(2) Each redemption order for securities of a mutual fund received by a participating dealer at its principal office, by the principal distributor of the mutual fund at a location that is not an order receipt office of the mutual fund, or a person or company providing services to the participating dealer or principal distributor must, on the day the order is received, be sent by same day or next day courier, same day or next day priority post, telephone or electronic means, without charge to the relevant securityholder or to the mutual fund, to an order receipt office of the mutual fund.

(3) Despite subsections (1) and (2), a redemption order for securities of a mutual fund received at a location referred to in those subsections after normal business hours on a business day, or on a day that is not a business day, may be sent, in the manner and to the place required by those subsections, on the next business day.

(4) A participating dealer, a principal distributor, or a person or company providing services to the participating dealer or principal distributor, that sends redemption orders electronically may

(a) specify a time on a business day by which a redemption order must be received in order that it be sent electronically on that business day; and

(b) despite subsections (1) and (2), send electronically on the next business day a redemption order received after the time specified under paragraph (a).

(5) A mutual fund is deemed to have received a redemption order for securities of the mutual fund when the order is received at an order receipt office of the mutual fund or all requirements of the mutual fund established under paragraph 10.1(2)(a) have been satisfied, whichever is later.

(6) If a mutual fund determines that its requirements established under paragraph 10.1(2)(a) have not been satisfied, the mutual fund must notify the securityholder making the redemption order, by the close of business on the business day after the date of the delivery to the mutual fund of the incomplete redemption order, that its requirements established under paragraph 10.1(2)(a) have not been satisfied and must specify procedures still to be followed or the documents still to be delivered by that securityholder.

(7) Despite subsection (5), a mutual fund may provide that orders for the redemption of securities that are received at an order receipt office of the mutual fund after a specified time on a business day, or on a day that is not a business day, will be considered to be received by the mutual fund on the next business day following the day of actual receipt.

10.3 Redemption Price of Securities – (1) The redemption price of a security of a mutual fund to which a redemption order pertains must be the net asset value per security of that class, or series of a class, next determined after the receipt by the mutual fund of the order.

(2) Despite subsection (1), the redemption price of a security of an exchange-traded mutual fund that is not in continuous distribution may be a price that is less than the net asset value of the security and that is determined on a date specified in the exchange-traded mutual fund's prospectus or annual information form.

(3) Despite subsection (1), the redemption price of a security of an exchange-traded mutual fund that is in continuous distribution may, if a securityholder redeems fewer than the manager-prescribed number of units, be a price that is calculated by reference to the closing price of the security on the stock exchange on which the security is listed and posted for trading, next determined after the receipt by the exchange-traded mutual fund of the redemption order.

(4) The redemption price of a security of a non-redeemable investment fund must not be a price that is more than the net asset value of the security determined on a redemption date specified in the prospectus or annual information form of the investment fund.

(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 first or 2nd business day after the date of receipt by the alternative fund of the redemption order.

10.4 Payment of Redemption Proceeds – (1) Subject to subsection 10.1(1) and to compliance with any requirements established by the mutual fund under paragraph 10.1(2)(b), a mutual fund must pay the redemption proceeds for securities that are the subject of a redemption order

(a) within three business days after the date of calculation of the net asset value per security used in establishing the redemption price; or

(b) if payment of the redemption proceeds was not made at the time referred to in paragraph (a) because a requirement established under paragraph 10.1(2)(b) or a requirement of subsection 10.1(1) had not been satisfied, within three business days of

(i) the satisfaction of the relevant requirement, or

(ii) the decision by the mutual fund to waive the requirement, if the requirement was a requirement established under paragraph 10.1(2)(b).

(1.1) Despite subsection (1), an alternative fund or an exchange-traded mutual fund that is not in continuous distribution must pay the redemption proceeds for securities that are the subject of a redemption order no later than 15 business days after the valuation date on which the redemption price was established.

(1.2) A non-redeemable investment fund must pay the redemption proceeds for securities that are the subject of a redemption order no later than 15 business days after the valuation date on which the redemption price was established.

(2) The redemption proceeds for a redeemed security, less any applicable investor fees, must be paid to or to the order of the securityholder of the security.

(3) An investment fund must pay the redemption proceeds for a redeemed security by using any or a combination of the following methods of payment:

(a) by paying cash in the currency in which the net asset value per security of the redeemed security was calculated;

(b) with the prior written consent of the securityholder for a redemption other than an exchange of a manager-prescribed number of units, by making good delivery to the securityholder of portfolio assets, the value of which is equal to the amount at which those portfolio assets were valued in calculating the net asset value per security used to establish the redemption price.

(4) [Repealed]

(5) If the redemption proceeds for a redeemed security are paid in currency, an investment fund is deemed to have made payment

(a) when the investment fund, its manager or principal distributor mails a cheque or transmits funds in the required amount to or to the order of the securityholder of the securities; or

(b) if the securityholder has requested that redemption proceeds be delivered in a currency other than that permitted in subsection (3), when the investment fund delivers the redemption proceeds to the manager or principal distributor of the investment fund for conversion into that currency and delivery forthwith to the securityholder.

10.5 Failure to Complete Redemption Order – (1) If a requirement of a mutual fund referred to in subsection 10.1(1) or established under paragraph 10.1(2)(b) has not been satisfied on or before the close of business on the tenth business day after the date of the redemption of the relevant securities, and, in the case of a requirement established under paragraph 10.1(2)(b), the mutual fund does not waive satisfaction of the requirement, the mutual fund must

(a) issue, to the person or company that immediately before the redemption held the securities that were redeemed, a number of securities equal to the number of securities that were redeemed, as if the mutual fund had received from the person or company on the tenth business day after the redemption, and accepted immediately before the close of business on the tenth business day after the redemption, an order for the purchase of that number of securities; and

(b) apply the amount of the redemption proceeds to the payment of the issue price of the securities.

(2) If the amount of the issue price of the securities referred to in subsection (1) is less than the redemption proceeds, the difference must belong to the mutual fund.

(3) If the amount of the issue price of the securities referred to in subsection (1) exceeds the redemption proceeds

(a) if the mutual fund has a principal distributor, the principal distributor must pay immediately to the mutual fund the amount of the deficiency;

(b) if the mutual fund does not have a principal distributor, the participating dealer that delivered the relevant redemption order to the mutual fund must pay immediately to the mutual fund the amount of the deficiency; or

(c) if the mutual fund has no principal distributor and no dealer delivered the relevant redemption order to the mutual fund, the manager of the mutual fund must pay immediately to the mutual fund the amount of the deficiency.

10.6 Suspension of Redemptions – (1) An investment fund may suspend the right of securityholders to request that the investment fund redeem its securities for the whole or any part of a period during which either of the following occurs:

(a) normal trading is suspended on a stock exchange, options exchange or futures exchange within or outside Canada on which securities are listed and posted for trading, or on which specified derivatives are traded, if those securities or specified derivatives represent more than 50% by value, or underlying market exposure, of the total assets of the investment fund without allowance for liabilities and if those securities or specified derivatives are not traded on any other exchange that represents a reasonably practical alternative for the investment fund;

(b) in the case of a clone fund, the investment fund whose performance it tracks has suspended redemptions.

(2) An investment fund that has an obligation to pay the redemption proceeds for securities that have been redeemed in accordance with subsection 10.4(1), (1.1) or (1.2) may postpone payment during a period in which the right of securityholders to request redemption of their securities is suspended, whether that suspension was made under subsection (1) or pursuant to an approval of the securities regulatory authority or regulator.

(3) An investment fund must not accept a purchase order for securities of the investment fund during a period in which it is exercising rights under subsection (1) or at a time in which it is relying on an approval of the securities regulatory authority or regulator contemplated by paragraph 5.5(1)(d).

PART 11 COMMINGLING OF CASH

11.1 Principal Distributors and Service Providers – (1) Cash received by a principal distributor of a mutual fund, by a person or company providing services to the mutual fund or the principal distributor, or by a person or company providing services to a non-redeemable investment fund, for investment in, or on the redemption of, securities of the investment fund, or on the distribution of assets of the investment fund, until disbursed as permitted by subsection (3),

(a) must be accounted for separately and be deposited in a trust account or trust accounts established and maintained in accordance with the requirements of section 11.3, and

(b) may be commingled only with cash received by the principal distributor or service provider for the sale or on the redemption of other investment fund securities.

(2) Except as permitted by subsection (3), the principal distributor, a person or company providing services to the mutual fund or principal distributor, or a person or company providing services to the non-redeemable investment fund, must not use any of the cash referred to in subsection (1) to finance its own or any other operations in any way.

(3) The principal distributor or person or company providing services to an investment fund or principal distributor may withdraw cash from a trust account referred to in paragraph (1)(a) for any of the following purposes:

(a) remitting to the investment fund the amount or, if subsection (5) applies, the net amount, to be invested in the securities of the investment fund;

(b) remitting to the relevant persons or companies redemption or distribution proceeds being paid on behalf of the investment fund;

(c) paying fees, charges and expenses that are payable by an investor in connection with the purchase, conversion, holding, transfer or redemption of securities of the investment fund.

(4) All interest earned on cash held in a trust account referred to in paragraph (1)(a) must be paid to securityholders or to each of the investment funds to which the trust account pertains, pro rata based on cash flow,

(a) no less frequently than monthly if the amount owing to an investment fund or to a securityholder is $10 or more; and

(b) no less frequently than once a year.

(5) When making payments to an investment fund, the principal distributor or service provider may offset the proceeds of redemption of securities of the investment fund or amounts held for distributions to be paid on behalf of the investment fund held in the trust account against amounts held in the trust account for investment in the investment fund.

11.2 Participating Dealers – (1) Cash received by a participating dealer, or by a person or company providing services to a participating dealer, for investment in, or on the redemption of, securities of a mutual fund, or on the distribution of assets of a mutual fund, until disbursed as permitted by subsection (3)

(a) must be accounted for separately and must be deposited in a trust account or trust accounts established and maintained in accordance with section 11.3; and

(b) may be commingled only with cash received by the participating dealer or service provider for the sale or on the redemption of other mutual fund securities.

(2) Except as permitted by subsection (3), the participating dealer or person or company providing services to the participating dealer must not use any of the cash referred to in subsection (1) to finance its own or any other operations in any way.

(3) A participating dealer or person or company providing services to the participating dealer may withdraw cash from a trust account referred to in paragraph (1)(a) for the purpose of

(a) remitting to the mutual fund or the principal distributor of the mutual fund the amount or, if subsection (5) applies, the net amount, to be invested in the securities of the mutual fund;

(b) remitting to the relevant persons or companies redemption or distribution proceeds being paid on behalf of the mutual fund; or

(c) paying fees, charges and expenses that are payable by an investor in connection with the purchase, conversion, holding, transfer or redemption of securities of the mutual fund.

(4) All interest earned on cash held in a trust account referred to in paragraph (1)(a) must be paid to securityholders or to each of the mutual funds to which the trust account pertains, pro rata based on cash flow,

(a) no less frequently than monthly if the amount owing to a mutual fund or to a securityholder is $10 or more; and

(b) no less frequently than once a year.

(5) When making payments to a mutual fund, a participating dealer or service provider may offset the proceeds of redemption of securities of the mutual fund and amounts held for distributions to be paid on behalf of a mutual fund held in the trust account against amounts held in the trust account for investment in the mutual fund.

(6) A participating dealer or person providing services to the participating dealer must permit the mutual fund and the principal distributor, through their respective auditors or other designated representatives, to examine the books and records of the participating dealer to verify the compliance with this section of the participating dealer or person providing services.

11.3 Trust Accounts – A principal distributor or participating dealer, a person or company providing services to the principal distributor or participating dealer, or a person or company providing services to an investment fund, that deposits cash into a trust account in accordance with section 11.1 or 11.2 must

(a) advise, in writing, the financial institution with which the account is opened at the time of the opening of the account and annually thereafter, that

(i) the account is established for the purpose of holding client funds in trust,

(ii) the account is to be labelled by the financial institution as a “trust account”,

(iii) the account is not to be accessed by any person other than authorized representatives of the principal distributor or participating dealer, of a person or company providing services to the principal distributor or participating dealer, or of a person or company providing services to the investment fund, and

(iv) the cash in the trust account may not be used to cover shortfalls in any accounts of the principal distributor or participating dealer, of a person or company providing services to the principal distributor or participating dealer, or of a person or company providing services to the investment fund;

(b) ensure that the trust account bears interest at rates equivalent to comparable accounts of the financial institution; and

(c) ensure that any charges against the trust account are not paid or reimbursed out of the trust account.

11.4 Exemption – (1) Sections 11.1 and 11.2 do not apply to a member of IIROC.

(1.1) Except in Québec, sections 11.1 and 11.2 do not apply to a member of the MFDA.

(1.2) In Québec, sections 11.1 and 11.2 do not apply to a mutual fund dealer.

(1.3) Section 11.1 does not apply to CDS Clearing and Depository Services Inc.

(2) A participating dealer that is a member of an SRO referred to in subsection (1) or (1.1) or, in Québec, that is a mutual fund dealer, must permit the mutual fund and the principal distributor, through their respective auditors or other designated representatives, to examine the books and records of the participating dealer to verify the participating dealer's compliance with the requirements of its association or exchange, or the requirements applicable to the mutual fund dealer under the regulations in Québec, that relate to the commingling of cash.

11.5 Right of Inspection – The investment fund, its trustee, manager and principal distributor must ensure that all contractual arrangements made between any of them and any person or company providing services to the investment fund permit the representatives of the investment fund, its manager and trustee to examine the books and records of those persons or companies in order to monitor compliance with this Instrument.

PART 12 COMPLIANCE REPORTS

12.1 Compliance Reports – (1) A mutual fund, other than an exchange-traded mutual fund that is not in continuous distribution, that does not have a principal distributor must complete and file, within 140 days after the financial year end of the mutual fund

(a) a report in the form contained in Appendix B-1 describing compliance by the mutual fund during that financial year with the applicable requirements of Parts 9, 10 and 11; and

(b) a report by the auditor of the mutual fund, in the form contained in Appendix B-1, concerning the report referred to in paragraph (a).

(2) The principal distributor of a mutual fund must complete and file, within 90 days after the financial year end of the principal distributor

(a) a report in the form contained in Appendix B-2 describing compliance by the principal distributor during that financial year with the applicable requirements of Parts 9, 10 and 11; and

(b) a report by the auditor of the principal distributor or by the auditor of the mutual fund, in the form contained in Appendix B-2, concerning the report referred to in paragraph (a).

(3) Each participating dealer that distributes securities of a mutual fund in a financial year of the participating dealer must complete and file, within 90 days after the end of that financial year

(a) a report in the form contained in Appendix B-3 describing compliance by the participating dealer during that financial year with the applicable requirements of Parts 9, 10 and 11 in connection with its distribution of securities of all mutual funds in that financial year; and

(b) a report by the auditor of the participating dealer, in the form contained in Appendix B-3, concerning the report referred to in paragraph (a).

(4) Subsections (2) and (3) do not apply to a member of IIROC.

(4.1) Except in Québec, subsections (2) and (3) do not apply to a member of the MFDA.

(4.2) In Québec, subsections (2) and (3) do not apply to a mutual fund dealer.

PART 13 [Repealed]

PART 14 RECORD DATE

14.0.1 Application – This Part does not apply to an exchange-traded mutual fund.

14.1 Record Date – The record date for determining the right of securityholders of a mutual fund to receive a dividend or distribution by the mutual fund must be one of

(a) the day on which the net asset value per security is determined for the purpose of calculating the amount of the payment of the dividend or distribution;

(b) the last day on which the net asset value per security of the mutual fund was calculated before the day referred to in paragraph (a); or

(c) if the day referred to in paragraph (b) is not a business day, the last day on which the net asset value per security of the mutual fund was calculated before the day referred to in paragraph (b).

PART 15 SALES COMMUNICATIONS AND PROHIBITED REPRESENTATIONS

15.1 Ability to Make Sales Communications - Sales communications pertaining to an investment fund must be made by a person or company in accordance with this Part.

15.2 Sales Communications - General Requirements – (1) Despite any other provision of this Part, a sales communication must not

(a) be untrue or misleading; or

(b) include a statement that conflicts with information that is contained in the preliminary prospectus, the preliminary annual information form, the preliminary fund facts document, the prospectus, the annual information form or the fund facts document, as applicable,

(i) of an investment fund, or

(ii) in which an asset allocation service is described.

(2) All performance data or disclosure specifically required by this Instrument and contained in a written sales communication must be at least as large as 10-point type.

15.3 Prohibited Disclosure in Sales Communications – (1) A sales communication must not compare the performance of an investment fund or asset allocation service with the performance or change of any benchmark or investment unless

(a) it includes all facts that, if disclosed, would be likely to alter materially the conclusions reasonably drawn or implied by the comparison;

(b) it presents data for each subject of the comparison for the same period or periods;

(c) it explains clearly any factors necessary to make the comparison fair and not misleading; and

(d) in the case of a comparison with a benchmark

(i) the benchmark existed and was widely recognized and available during the period for which the comparison is made, or

(ii) the benchmark did not exist for all or part of the period, but a reconstruction or
calculation of what the benchmark would have been during that period, calculated on a basis consistent with its current basis of calculation, is widely recognized and available.

(2) A sales communication for a mutual fund or asset allocation service that is prohibited by paragraph 15.6(1)(a) from disclosing performance data must not provide performance data for any benchmark or investment other than a mutual fund or asset allocation service under common management with the mutual fund or asset allocation service to which the sales communication pertains.

(2.1) A sales communication for a non-redeemable investment fund that is restricted by paragraph 15.6(1)(a) from disclosing performance data must not provide performance data for any benchmark or investment, other than a non-redeemable investment fund under common management with the non-redeemable investment fund to which the sales communication pertains.

(3) Despite subsection (2), a sales communication for an index mutual fund may provide performance data for the index on which the investments of the mutual fund are based if the index complies with the requirements for benchmarks contained in paragraph (1)(d).

(4) A sales communication must not refer to a performance rating or ranking of a mutual fund or asset allocation service unless

(a) the rating or ranking is prepared by a mutual fund rating entity;

(b) standard performance data is provided for any mutual fund or asset allocation service for which a performance rating or ranking is given;

(c) the rating or ranking is provided for each period for which standard performance data is required to be given, except the period since the inception of the mutual fund;

(d) the rating or ranking is based on a published category of mutual funds that

(i) provides a reasonable basis for evaluating the performance of the mutual fund or asset allocation service, and

(ii) is not established or maintained by a member of the organization of the mutual fund or asset allocation service;

(e) the sales communication contains the following disclosure:

(i) the name of the category within which the mutual fund or asset allocation service is rated or ranked, including the name of the organization that maintains the category,

(ii) the number of mutual funds in the applicable category for each period of standard performance data required under paragraph (c),

(iii) the name of the mutual fund rating entity that provided the rating or ranking,

(iv) the length of the period or the first day of the period on which the rating or ranking is based, and its ending date,

(v) a statement that the rating or ranking is subject to change every month,

(vi) the criteria on which the rating or ranking is based, and

(vii) if the rating or ranking consists of a symbol rather than a number, the meaning of the symbol, and

(f) the rating or ranking is to the same calendar month end that is

(i) not more than 45 days before the date of the appearance or use of the advertisement in which it is included, and

(ii) not more than three months before the date of first publication of any other sales communication in which it is included.

(4.1) Despite paragraph (4)(c), a sales communication may refer to an overall rating or ranking of a mutual fund or asset allocation service in addition to each rating or ranking required under paragraph (4)(c) if the sales communication otherwise complies with the requirements of subsection (4).

(5) A sales communication must not refer to a credit rating of securities of an investment fund unless

(a) the rating is current and was prepared by a designated rating organization or its DRO affiliate;

(b) there has been no announcement by the designated rating organization or any of its DRO affiliates of which the investment fund or its manager is or ought to be aware that the credit rating of the securities may be down-graded; and

(c) no designated rating organization or any of its DRO affiliates is currently rating the securities at a lower level.

(6) A sales communication must not refer to a mutual fund as, or imply that it is, a money fund, cash fund or money market fund unless, at the time the sales communication is used and for each period for which money market fund standard performance data is provided, the mutual fund is and was a money market fund under this Instrument.

(7) A sales communication must not state or imply that a registered retirement savings plan, registered retirement income fund or registered education savings plan in itself, rather than the investment fund to which the sales communication relates, is an investment.

15.4 Required Disclosure and Warnings in Sales Communications – (1) A written sales communication must

(a) bear the name of the dealer that distributed the sales communication; and

(b) if the sales communication is not an advertisement, contain the date of first publication of the sales communication.

(2) A sales communication that includes a rate of return or a mathematical table illustrating the potential effect of a compound rate of return must contain a statement in substantially the following words:

> "[The rate of return or mathematical table shown] is used only to illustrate the effects of the compound growth rate and is not intended to reflect future values of [the investment fund or asset allocation service] or returns on investment [in the investment fund or from the use of the asset allocation service].".

(3) A sales communication, other than a report to securityholders, of a mutual fund that is not a money market fund and that does not contain performance data must contain a warning in substantially the following words:

> "Commissions, trailing commissions, management fees and expenses all may be associated with mutual fund investments. Please read the prospectus before

investing. Mutual funds are not guaranteed, their values change frequently and past performance may not be repeated.".

(3.1) A sales communication, other than a report to securityholders, of a non-redeemable investment fund that does not contain performance data must contain a warning in substantially the following words:

> [If the securities of the non-redeemable investment fund are listed or quoted on an exchange or other market, state the following:] "You will usually pay brokerage fees to your dealer if you purchase or sell [units or shares] of the investment fund on [state the exchange or other market on which the securities of the investment fund are listed or quoted]. If the [units or shares] are purchased or sold on [state the exchange or other market], investors may pay more than the current net asset value when buying [units or shares] of the investment fund and may receive less than the current net asset value when selling them."
>
> [State the following in all cases:] "There are ongoing fees and expenses associated with owning [units or shares] of an investment fund. An investment fund must prepare disclosure documents that contain key information about the fund. You can find more detailed information about the fund in these documents. Investment funds are not guaranteed, their values change frequently and past performance may not be repeated.".

(4) A sales communication, other than a report to securityholders, of a money market fund that does not contain performance data must contain a warning in substantially the following words:

> "Commissions, trailing commissions, management fees and expenses all may be associated with mutual fund investments. Please read the prospectus before investing. Mutual fund securities are not covered by the Canada Deposit Insurance Corporation or by any other government deposit insurer. There can be no assurances that the fund will be able to maintain its net asset value per security at a constant amount or that the full amount of your investment in the fund will be returned to you. Past performance may not be repeated.".

(5) A sales communication for an asset allocation service that does not contain performance data must contain a warning in substantially the following words:

> "Commissions, trailing commissions, management fees and expenses all may be associated with mutual fund investments and the use of an asset allocation service. Please read the prospectus of the mutual funds in which investment may be made under the asset allocation service before investing. Mutual funds are not guaranteed, their values change frequently and past performance may not be repeated.".

(6) A sales communication, other than a report to securityholders, of a mutual fund that is not a money market fund and that contains performance data must contain a warning in substantially the following words:

> "Commissions, trailing commissions, management fees and expenses all may be associated with mutual fund investments. Please read the prospectus before investing. The indicated rate[s] of return is [are] the historical annual compounded total return[s] including changes in [share or unit] value and reinvestment of all [dividends or distributions] and does [do] not take into account sales, redemption, distribution or optional charges or income taxes payable by any securityholder that would have reduced returns. Mutual funds are not guaranteed, their values change frequently and past performance may not be repeated.".

(6.1) A sales communication, other than a report to securityholders, of a non-redeemable investment fund that contains performance data must contain a warning in substantially the following words:

> [If the securities of the non-redeemable investment fund are listed or quoted on an exchange or other market, state the following:] "You will usually pay brokerage fees to your dealer if you purchase or sell [units or shares] of the investment fund on [state the exchange or other market on which the securities of the investment fund are listed or quoted]. If the [units or shares] are purchased or sold on [state the exchange or other market], investors may pay more than the current net asset value when buying [units or shares] of the investment fund and may receive less than the current net asset value when selling them."
>
> [State the following in all cases:] "There are ongoing fees and expenses associated with owning [units or shares] of an investment fund. An investment fund must prepare disclosure documents that contain key information about the fund. You can find more detailed information about the fund in these documents. The indicated rate[s] of return is [are] the historical annual compounded total return[s] including changes in [share or unit] value and reinvestment of all [dividends or distributions] and does [do] not take into account [state the following, as applicable:] [certain fees such as redemption fees or optional charges or] income taxes payable by any securityholder that would have reduced returns. Investment funds are not guaranteed, their values change frequently and past performance may not be repeated.".

(7) A sales communication, other than a report to securityholders, of a money market fund that contains performance data must contain

(a) a warning in substantially the following words:

> "Commissions, trailing commissions, management fees and expenses all may be associated with mutual fund investments. Please read the prospectus before investing. The performance data provided assumes reinvestment of distributions only and does not take into account sales, redemption, distribution or optional charges or income taxes payable by any securityholder that would have reduced returns. Mutual fund securities are not covered by the Canada Deposit Insurance Corporation or by any

other government deposit insurer. There can be no assurances that the fund will be able to maintain its net asset value per security at a constant amount or that the full amount of your investment in the fund will be returned to you. Past performance may not be repeated."; and

(b) a statement in substantially the following words, immediately following the performance data:

"This is an annualized historical yield based on the seven day period ended on [date] [annualized in the case of effective yield by compounding the seven day return] and does not represent an actual one year return.".

(8) A sales communication for an asset allocation service that contains performance data must contain a warning in substantially the following words:

"Commissions, trailing commissions, management fees and expenses all may be associated with mutual fund investments and the use of an asset allocation service. Please read the prospectus of the mutual funds in which investment may be made under the asset allocation service before investing. The indicated rate[s] of return is [are] the historical annual compounded total return[s] assuming the investment strategy recommended by the asset allocation service is used and after deduction of the fees and charges in respect of the service. The return[s] is [are] based on the historical annual compounded total returns of the participating funds including changes in [share] [unit] value and reinvestment of all [dividends or distributions] and does [do] not take into account sales, redemption, distribution or optional charges or income taxes payable by any securityholder in respect of a participating fund that would have reduced returns. Mutual funds are not guaranteed, their values change frequently and past performance may not be repeated.".

(9) A sales communication distributed after the issue of a receipt for a preliminary prospectus of the mutual fund described in the sales communication but before the issue of a receipt for its prospectus must contain a warning in substantially the following words:

"A preliminary prospectus relating to the fund has been filed with certain Canadian securities commissions or similar authorities. You cannot buy [units] [shares] of the fund until the relevant securities commissions or similar authorities issue receipts for the prospectus of the fund.".

(10) A sales communication for an investment fund or asset allocation service that purports to arrange a guarantee or insurance in order to protect all or some of the principal amount of an investment in the investment fund or asset allocation service must

(a) identify the person or company providing the guarantee or insurance;

(b) provide the material terms of the guarantee or insurance, including the maturity date of the guarantee or insurance;

(c) if applicable, state that the guarantee or insurance does not apply to the amount of any redemptions before the maturity date of the guarantee or before the death of the securityholder and that redemptions before that date would be

based on the net asset value per security of the investment fund at the time; and

(d) modify any other disclosure required by this section appropriately.

(11) The warnings referred to in this section must be communicated in a manner that a reasonable person would consider clear and easily understood at the same time as, and through the medium by which, the related sales communication is communicated.

15.5 Disclosure Regarding Distribution Fees – (1) A person or company must not describe a mutual fund in a sales communication as a "no-load fund" or use words of like effect if on a purchase or redemption of securities of the mutual fund investor fees are payable by an investor or if any fees, charges or expenses are payable by an investor to a participating dealer of the mutual fund named in the sales communication, other than

(a) fees and charges related to specific optional services;

(b) for a mutual fund that is not a money market fund, redemption fees on the redemption of securities of the mutual fund that are redeemed within 90 days after the purchase of the securities, if the existence of the fees is disclosed in the sales communication, or in the prospectus of the mutual fund; or

(c) costs that are payable only on the set-up or closing of a securityholder's account and that reflect the administrative costs of establishing or closing the account, if the existence of the costs is disclosed in the sales communication, or in the prospectus of the mutual fund.

(2) If a sales communication describes a mutual fund as "no-load" or uses words to like effect, the sales communication must

(a) indicate the principal distributor or a participating dealer through which an investor may purchase the mutual fund on a no-load basis;

(b) disclose that management fees and operating expenses are paid by the mutual fund; and

(c) disclose the existence of any trailing commissions paid by a member of the organization of the mutual fund.

(3) A sales communication containing a reference to the existence or absence of fees or charges, other than the disclosure required by section 15.4 or a reference to the term "no-load", must disclose the types of fees and charges that exist.

(4) The rate of sales charges or commissions for the sale of securities of a mutual fund or the use of an asset allocation service must be expressed in a sales communication as a percentage of the amount paid by the purchaser and as a percentage of the net amount invested if a reference is made to sales charges or commissions.

15.6 Performance Data - General Requirements – (1) A sales communication pertaining to an investment fund or asset allocation service must not contain performance data of the investment fund or asset allocation service unless all of the following paragraphs apply:

(a) one of the following subparagraphs applies:

(i) in the case of a mutual fund, either of the following applies:

(A) the mutual fund has distributed securities under a prospectus in a jurisdiction for a period of at least 12 consecutive months;

(B) the mutual fund previously existed as a non-redeemable investment fund and has been a reporting issuer in a jurisdiction for a period of at least 12 consecutive months;

(ii) in the case of a non-redeemable investment fund, the non-redeemable investment fund has been a reporting issuer in a jurisdiction for at least 12 consecutive months;

(iii) in the case of an asset allocation service, the asset allocation service has been operated for at least 12 consecutive months and has invested only in participating funds each of which has distributed securities under a prospectus in a jurisdiction for at least 12 consecutive months;

(iv) if the sales communication pertains to an investment fund or asset allocation service that does not satisfy subparagraph (i), (ii) or (iii), the sales communication is sent only to one of the following:

(A) securityholders of the investment fund or participants in the asset allocation service;

(B) securityholders of an investment fund or participants in an asset allocation service under common management with the investment fund or asset allocation service;

(b) the sales communication includes standard performance data of the investment fund or asset allocation service and, in the case of a written sales communication, the standard performance data is presented in type size that is equal to or larger than that used to present the other performance data;

(c) the performance data reflects or includes references to all elements of return;

(d) except as permitted by subsection 15.3(3), the sales communication does not contain performance data for a period that is,

(i) in the case of a mutual fund, before the time when the mutual fund offered its securities under a prospectus;

(ii) in the case of a non-redeemable investment fund, before the non-redeemable investment fund was a reporting issuer;

(iii) in the case of an asset allocation service, before the asset allocation service commenced operation.

(2) Despite subparagraph (1)(d)(i), a sales communication pertaining to a mutual fund referred to in clause (1)(a)(i)(B) that contains performance data of the mutual fund must include performance data for the period that the fund existed as a non-redeemable investment fund and was a reporting issuer.

15.7 Advertisements – An advertisement for a mutual fund or asset allocation service must not compare the performance of the mutual fund or asset allocation service with any benchmark or investment other than

(a) one or more mutual funds or asset allocation services that are under common management or administration with the mutual fund or asset allocation service to which the advertisement pertains;

(b) one or more mutual funds or asset allocation services that have fundamental investment objectives that a reasonable person would consider similar to the mutual fund or asset allocation service to which the advertisement pertains; or

(c) an index.

15.7.1 Advertisements for Non-Redeemable Investment Funds – An advertisement for a non-redeemable investment fund must not compare the performance of the non-redeemable investment fund with any benchmark or investment other than any of the following:

(a) one or more non-redeemable investment funds that are under common management or administration with the non-redeemable investment fund to which the advertisement pertains;

(b) one or more non-redeemable investment funds that have fundamental investment objectives that a reasonable person would consider similar to the non-redeemable investment fund to which the advertisement pertains;

(c) an index.

15.8 Performance Measurement Periods Covered by Performance Data – (1) A sales communication, other than a report to securityholders, that relates to a money market fund may provide standard performance data only if

(a) the standard performance data has been calculated for the most recent seven day period for which it is practicable to calculate, taking into account publication deadlines; and

(b) the seven day period does not start more than 45 days before the date of the appearance, use or publication of the sales communication.

(2) A sales communication, other than a report to securityholders, that relates to an asset allocation service, or to an investment fund other than a money market fund, must not provide standard performance data unless,

(a) to the extent applicable, the standard performance data has been calculated for 10, 5, 3 and one year periods,

(a.1) in the case of a mutual fund that has been offering securities by way of prospectus for more than one and less than 10 years, the standard performance data has been calculated for the period since the inception of the mutual fund,

(a.2) in the case of a non-redeemable investment fund that has been a reporting issuer for more than one and less than 10 years, the standard performance data has been calculated for the period since the inception of the non-redeemable investment fund, and

(b) the periods referred to in paragraphs (a), (a.1) and (a.2) end on the same calendar month end that is

(i) not more than 45 days before the date of the appearance or use of the advertisement in which it is included, and

(ii) not more than three months before the date of first publication of any other sales communication in which it is included.

(3) A report to securityholders must not contain standard performance data unless,

(a) to the extent applicable, the standard performance data has been calculated for 10, 5, 3 and one year periods,

(a.1) in the case of a mutual fund that has been offering securities by way of prospectus for more than one and less than 10 years, the standard performance data has been calculated for the period since the inception of the mutual fund,

(a.2) in the case of a non-redeemable investment fund that has been a reporting issuer for more than one and less than 10 years, the standard performance data has been calculated for the period since the inception of the non-redeemable investment fund, and

(b) the periods referred to in paragraphs (a), (a.1) and (a.2) end on the day as of which the statement of financial position of the financial statements contained in the report to securityholders was prepared.

(4) A sales communication must clearly identify the periods for which performance data is calculated.

15.9 Changes affecting Performance Data – (1) If, during or after a performance measurement period of performance data contained in a sales communication, there have been changes in the business, operations or affairs of the investment fund or asset allocation service to which the sales communication pertains that could have materially affected the performance of the investment fund or asset allocation service, the sales communication must contain

(a) summary disclosure of the changes, and of how those changes could have affected the performance had those changes been in effect throughout the performance measurement period; and

(b) for a money market fund that during the performance measurement period did not pay or accrue the full amount of any fees and charges of the type described under paragraph 15.11(1)1, disclosure of the difference between the full amounts and the amounts actually charged, expressed as an annualized percentage on a basis comparable to current yield.

(2) If an investment fund has, in the last 10 years, undertaken a reorganization with, or acquired assets from, another investment fund in a transaction that was a material change for the investment fund or would have been a material change for the investment fund had this Instrument been in force at the time of the transaction, then, in any sales communication of the investment fund,

(a) the investment fund must provide summary disclosure of the transaction;

(b) the investment fund may include its performance data covering any part of a period before the transaction only if it also includes the performance data for the other fund for the same periods;

(c) the investment fund must not include its performance data for any part of a period after the transaction unless

(i) 12 months have passed since the transaction, or

(ii) the investment fund includes in the sales communication the performance data for itself and the other investment fund referred to in paragraph (b); and

(d) the investment fund must not include any performance data for any period that is composed of both time before and after the transaction.

15.10 Formula for Calculating Standard Performance Data – (1) The standard performance data of an investment fund must be calculated in accordance with this Part.

(2) In this Part

"current yield" means the yield of a money market fund expressed as a percentage and determined by applying the following formula:

current yield = [seven day return x 365/7] x 100;

"effective yield" means the yield of a money market fund expressed as a percentage and determined by applying the following formula:

$$\text{effective yield} = [(\text{seven day return} + 1)^{365/7} - 1] \times 100;$$

"seven day return" means the income yield of an account of a securityholder in a money market fund that is calculated by

(a) determining the net change, exclusive of new subscriptions other than from the reinvestment of distributions or proceeds of redemption of securities of the money market fund, in the value of the account,

(b) subtracting all fees and charges of the type referred to in paragraph 15.11(1)3 for the seven day period, and

(c) dividing the result by the value of the account at the beginning of the seven day period;

"standard performance data" means, as calculated in each case in accordance with this Part,

(a) for a money market fund, either of the following:

(i) the current yield;

(ii) the current yield and effective yield, if the effective yield is reported in a type size that is at least equal to that of the current yield, and

(b) for any investment fund other than a money market fund, the total return; and

"total return" means the annual compounded rate of return for an investment fund for a period that would equate the initial value to the redeemable value at the end of the period, expressed as a percentage, and determined by applying the following formula:

$$\text{total return} = [(\text{redeemable value}/\text{initial value})^{(1/N)} - 1] \times 100$$

where N = the length of the performance measurement period in years, with a minimum value of 1.

(3) If there are fees and charges of the type described in paragraph 15.11(1)1 relevant to the calculation of redeemable value and initial value of the securities of an investment fund, the redeemable value and initial value of securities of an investment fund must be the net asset value of one unit or share of the investment fund at the beginning or at the end of the performance measurement period, minus the amount of those fees and charges calculated by applying the assumptions referred to in that paragraph to a hypothetical securityholder account.

(4) If there are no fees and charges of the type described in paragraph 15.11(1)1 relevant to a calculation of total return, the calculation of total return for an investment fund may assume a hypothetical investment of one security of the investment fund and be calculated as follows:

(a) "initial value" means the net asset value of one unit or share of an investment fund at the beginning of the performance measurement period; and

(b) "redeemable value" =

$$R \times (1 + D_1/P_1) \times (1 + D_2/P_2) \times (1 + D_3/P_3) \ldots \times (1 + D_n/P_n)$$

where R = the net asset value of one unit or security of the investment fund at the end of the performance measurement period,

D = the dividend or distribution amount per security of the investment fund at the time of each distribution,

P = the dividend or distribution reinvestment price per security of the investment fund at the time of each distribution, and

n = the number of dividends or distributions during the performance measurement period.

(5) Standard performance data of an asset allocation service must be based upon the standard performance data of its participating funds.

(6) Performance data

(a) for an investment fund other than a money market fund must be calculated to the nearest one-tenth of one percent; and

(b) for a money market fund must be calculated to the nearest one-hundredth of one percent.

15.11 Assumptions for Calculating Standard Performance Data – (1) The following assumptions must be made in the calculation of standard performance data of an investment fund:

1. Recurring fees and charges that are payable by all securityholders

(a) are accrued or paid in proportion to the length of the performance measurement period;

(b) if structured in a manner that would result in the performance information being dependent on the size of an investment, are calculated on the basis of an investment equal to the greater of $10,000 or the minimum amount that may be invested; and

(c) if fully negotiable, are calculated on the basis of the average fees paid by accounts of the size referred to in paragraph (b).

2. There are no fees and charges related to specific optional services.

3. All fees and charges payable by the investment fund are accrued or paid.

4. Dividends or distributions by the investment fund are reinvested in the investment fund at the net asset value per security of the investment fund on the reinvestment dates during the performance measurement period.

5. There are no non-recurring fees and charges that are payable by some or all securityholders and no recurring fees and charges that are payable by some but not all securityholders.

6. In the case of a mutual fund, a complete redemption occurs at the end of the performance measurement period so that the ending redeemable value includes elements of return that have been accrued but not yet paid to securityholders.

7. In the case of a non-redeemable investment fund, a complete redemption occurs at the net asset value of one security at the end of the performance measurement period so that the ending redeemable value includes elements of return that have been accrued but not yet paid to securityholders.

(2) The following assumptions must be made in the calculation of standard performance data of an asset allocation service:

1. Fees and charges that are payable by participants in the asset allocation service

(a) are accrued or paid in proportion to the length of the performance measurement period;

(b) if structured in a manner that would result in the performance information being dependent on the size of an investment, are calculated on the basis of an investment equal to the greater of $10,000 or the minimum amount that may be invested; and

(c) if fully negotiable, are calculated on the basis of the average fees paid by accounts of the size referred to in paragraph (b).

2. There are no fees and charges related to specific optional services.

3. The investment strategy recommended by the asset allocation service is utilized for the performance measurement period.

4. Transfer fees are

(a) accrued or paid;

(b) if structured in a manner that would result in the performance information being dependent on the size of an investment, calculated on the basis of an

account equal to the greater of $10,000 or the minimum amount that may be invested; and

(c) if the fees and charges are fully negotiable, calculated on the basis of the average fees paid by an account of the size referred to in paragraph (b).

5. A complete redemption occurs at the end of the performance measurement period so that the ending redeemable value includes elements of return that have been accrued but not yet paid to securityholders.

(3) The calculation of standard performance data must be based on actual historical performance and the fees and charges payable by the investment fund and securityholders, or the asset allocation service and participants, in effect during the performance measurement period.

15.12 Sales Communications During the Waiting Period – If a sales communication is used after the issue of a receipt for a preliminary prospectus of the mutual fund described in the sales communication but before the issue of a receipt for its prospectus, the sales communication must state only

(a) whether the security represents a share in a corporation or an interest in a non-corporate entity;

(b) the name of the mutual fund and its manager;

(c) the fundamental investment objectives of the mutual fund;

(d) without giving details, whether the security is or will be a qualified investment for a registered retirement savings plan, registered retirement income fund or registered education savings plan or qualifies or will qualify the holder for special tax treatment; and

(e) any additional information permitted by securities legislation.

15.13 Prohibited Representations – (1) Securities issued by an unincorporated investment fund must be described by a term that is not and does not include the word “shares”.

(2) A communication by an investment fund or asset allocation service, its promoter, manager, portfolio adviser, principal distributor, participating dealer or a person providing services to the investment fund or asset allocation service must not describe the investment fund as ~~a commodity pool~~an alternative fund or as a vehicle for investors to participate in the speculative trading of, or leveraged ~~investment~~investments in, derivatives, unless the investment fund is ~~a commodity pool~~an alternative fund as defined in ~~National~~this Instrument ~~81-104 Commodity Pools~~..

15.14 Sales Communication - Multi-Class Investment Funds – A sales communication for an investment fund that distributes different classes or series of securities that are referable to the same portfolio must not contain performance data unless the sales communication complies with the following requirements:

1. The sales communication clearly specifies the class or series of security to which any performance data contained in the sales communication relates.

2. If the sales communication refers to more than one class or series of security and provides performance data for any one class or series, the sales communication must provide performance data for each class or series of security referred to in the sales communication and must clearly explain the reasons for different performance data among the classes or series.

3. A sales communication for a new class or series of security and an existing class or series of security must not contain performance data for the existing class or series unless the sales communication clearly explains any differences between the new class or series and the existing class or series that could affect performance.

PART 16 [Repealed]

PART 17 [Repealed]

PART 18 SECURITYHOLDER RECORDS

18.1 Maintenance of Records – An investment fund that is not a corporation must maintain, or cause to be maintained, up to date records of

(a) the names and latest known addresses of each securityholder of the investment fund;

(b) the number and class or series of a class of securities held by each securityholder of the investment fund; and

(c) the date and details of each issue and redemption of securities, and each distribution, of the investment fund.

18.2 Availability of Records – (1) An investment fund that is not a corporation must make, or cause to be made, the records referred to in section 18.1 available for inspection, free of charge, during normal business hours at its principal or head office by a securityholder or a representative of a securityholder, if the securityholder has agreed in writing that the information contained in the register will not be used by the securityholder for any purpose other than either of the following:

(a) in the case of a mutual fund, attempting to influence the voting of securityholders of the mutual fund or a matter relating to the relationships among the mutual fund, the members of the organization of the mutual fund, and the securityholders, partners, directors and officers of those entities;

(b) in the case of a non-redeemable investment fund, attempting to influence the voting of securityholders of the non-redeemable investment fund or a matter relating to the relationships among the non-redeemable investment fund, the manager and portfolio adviser of the non-redeemable investment fund and any of their affiliates, and the securityholders, partners, directors and officers of those entities.

(2) An investment fund must, upon written request by a securityholder of the investment fund, provide, or cause to be provided, to the securityholder a copy of the records referred to in paragraphs 18.1(a) and (b) if the securityholder

(a) has agreed in writing that the information contained in the register will not be used by the securityholder for any purpose other than attempting to influence the voting of securityholders of the investment fund or a matter relating to the administration of the investment fund; and

(b) has paid a reasonable fee to the investment fund that does not exceed the reasonable costs to the investment fund of providing the copy of the register.

PART 19 EXEMPTIONS AND APPROVALS

19.1 Exemption – (1) The regulator or securities regulatory authority may grant an exemption from this Instrument, in whole or in part, subject to such conditions or restrictions as may be imposed in the exemption.

(2) Despite subsection (1), in Ontario only the regulator may grant such an exemption.

19.2 Exemption or Approval under Prior Policy – (1) A mutual fund that has obtained, from the regulator or securities regulatory authority, an exemption or waiver from, or approval under, a provision of National Policy Statement No. 39 before this Instrument came into force is exempt from any substantially similar provision of this Instrument, if any, on the same conditions, if any, as are contained in the earlier exemption or approval, unless the regulator or securities regulatory authority has revoked that exemption or waiver under authority provided to it in securities legislation.

(2) Despite Part 7, a mutual fund that has obtained, from the regulator or securities regulatory authority, approval under National Policy Statement No. 39 to pay incentive fees may continue to pay incentive fees on the terms of that approval if disclosure of the method of calculation of the fees and details of the composition of the benchmark or index used in calculating the fees are described in the prospectus of the mutual fund.

(3) A mutual fund that intends to rely upon subsection (1) must, at the time of the first filing of its *pro forma* prospectus after this Instrument comes into force, send to the regulator a letter or memorandum containing

(a) a brief description of the nature of the exemption from, or approval under, National Policy Statement No. 39 previously obtained; and

(b) the provision in the Instrument that is substantially similar to the provision in National Policy Statement No. 39 from or under which the exemption or approval was previously obtained.

19.3 Revocation of Exemptions – (1) A mutual fund that has obtained an exemption or waiver from, or approval under, National Policy Statement No. 39 or this Instrument before December 31, 2003, that relates to a mutual fund investing in other mutual funds, may no longer rely on the exemption, waiver or approval as of December 31, 2004.

(2) In British Columbia, subsection (1) does not apply.

PART 20 TRANSITIONAL

20.1 Effective Date - This Instrument comes into force on February 1, 2000.

20.2 Sales Communications - Sales communications, other than advertisements, that were printed before December 31, 1999 may be used until August 1, 2000, despite any requirements in this Instrument.

20.3 Reports to Securityholders - This Instrument does not apply to reports to securityholders

(a) printed before February 1, 2000; or

(b) that include only financial statements that relate to financial periods that ended before February 1, 2000.

20.4 Mortgage Funds

(1) Paragraphs 2.3(1)(b) and (c) do not apply to a mutual fund that has adopted fundamental investment objectives to permit it to invest in mortgages in accordance with National Policy Statement No. 29 if

(a) a National Instrument replacing National Policy Statement No. 29 has not come into force;

(b) the mutual fund was established, and has a prospectus for which a receipt was issued, before the date that this Instrument came into force; and

(c) the mutual fund complies with National Policy Statement No. 29.

(2) If a non-redeemable investment fund has adopted fundamental investment objectives to permit it to invest in mortgages, paragraph 2.3(2)(b) does not apply to the non-redeemable investment fund, if the non-redeemable investment fund was established, and has a prospectus for which a receipt was issued, on or before September 22, 2014.

20.5 Delayed Coming into Force

(1) Despite section 20.1, subsection 4.4(1) does not come into force until August 1, 2000.

(2) Despite section 20.1, the following provisions of this Instrument do not come into force until February 1, 2001:

1. Subsection 2.4(2).

2. Subsection 2.7(4).

3. Subsection 6.4(1).

4. Subsection 6.8(4).

National Instrument 81-102 Appendix A

~~Futures Exchanges for the Purpose of~~
~~Subsection 2.7(4) - Derivative Counterparty Exposure Limits~~

~~Futures Exchanges~~

~~Australia~~
~~Sydney Futures Exchange~~
~~Australian Financial Futures Market~~

~~Austria~~
~~Osterreichische Termin und Option Borse (OTOB - The Austrian Options and Futures Exchange)~~

~~Belgium~~
~~Belfox CV (Belgium Futures and Options Exchange)~~

~~Brazil~~
~~Bolsa Brasileira de Futuros~~
~~Bolsa de Mercadorias~~
~~& Futuros Bolsa de~~
~~Valores de Rio de~~
~~Janeiro~~

~~Canada~~
~~The Winnipeg~~
~~Commodity Exchange~~
~~The Toronto Futures~~
~~Exchange The Montreal~~
~~Exchange~~

~~Denmark~~
~~Kobenhavus Fondsbors (Copenhagen Stock Exchange)~~
~~Garenti fonden for Dankse Optioner og Futures (Guarantee Fund for Danish Options and Futures) Futop (Copenhagen Stock Exchange)~~

~~Finland~~
~~Helsinki Stock Exchange~~
~~Oy Suomen Optiopörssi (Finnish~~
~~Options Exchange) Suomen~~
~~Optionmeklarit Oy (Finnish Options~~
~~Market)~~

~~France~~
~~Marché à terme international de France S.A. (MATIF S.A.)~~
~~Marché des option négociables à Paris (MUNCP)~~

~~Germany~~
~~DTB Deutsche Terminbörse GmbH~~
~~EUREX~~

~~Hong Kong~~
~~Hong Kong Futures Exchange Limited~~

~~Ireland~~
~~Irish Futures and Options Exchange~~

~~Italy~~
~~Milan Italiano Futures Exchange~~

~~Japan~~
~~Osaka Shoken Torihikisho (Osaka Securities Exchange)~~
~~The Tokyo Commodity Exchange for Industry~~
~~The Tokyo International Financial Futures Exchange Tokyo Grain Exchange~~
~~Tokyo Stock Exchange~~

~~Netherlands~~
~~AEX Options & Futures Exchange~~
~~EOE-Optiebeurs (European Options Exchange) Financiele Termijnmarkt Amsterdam N.V.~~

~~New Zealand~~
~~New Zealand Futures and Options Exchange~~

~~Norway~~
~~Oslo Stock Exchange~~

~~Philippines~~
~~Manila International Futures Exchange~~

~~Portugal~~
~~Bosa de Derivatives de Porto~~

~~Singapore~~
~~Singapore Commodity Exchange (SICOM)~~
~~Singapore International Monetary Exchange Limited (SIMEX)~~

~~Spain~~
~~Meff Renta Fija~~
~~Meff Renta Variable~~

~~Sweden~~
~~OM Stockholm Fondkommission AB~~

~~Switzerland~~
~~EUREX~~

~~United Kingdom~~
~~International Petroleum Exchange (IPE)~~
~~London International Financial Futures and Options Exchange (LIFFE) London Metal Exchange (LME)~~
~~OM London~~

[Repealed]

~~United States~~
~~Chicago Board of Options Exchange (CBOE)~~
~~Chicago Board of Trade (CBOT)~~
~~Chicago Mercantile Exchange (CME)~~
~~Commodity Exchange, Inc. (COMEX)~~
~~Financial Instrument Exchange (Finex) a division of the New York Cotton Exchange~~
~~Board of Trade of Kansas City, Missouri, Inc.~~
~~Mid-America Commodity Exchange~~
~~Minneapolis Grain Exchange (MGE)~~
~~New York Futures Exchange, Inc. (NYFE)~~
~~New York Mercantile Exchange (NYMECX)~~
~~New York Board of Trade (NYBOT)~~
~~Pacific Stock Exchange~~
~~Philadelphia Board of Trade (PBOT)~~
~~Twin Cities Board of Trade~~

National Instrument 81-102

Appendix B-1

Compliance Report

TO: [The appropriate securities regulatory authorities]

FROM: [Name of mutual fund]

RE: Compliance Report on National Instrument 81-102 For the year ended [insert date]

We hereby confirm that we have complied with the applicable requirements of Parts 9, 10 and 11 of National Instrument 81-102 for the year ended [insert date] [except as follows:] [list exceptions, if any].

[NAME of mutual fund]
…….Signature
…….Name and office of the person executing this report
……...Date

National Instrument 81-102

Appendix B-1

Audit Report

TO: [The appropriate securities regulatory authorities]

RE: Compliance Report on National Instrument 81-102 For the year ended [insert date]

We have audited [name of mutual fund]'s report made under section 12.1 of National Instrument 81-102 regarding its compliance for the year ended [insert date] with the applicable requirements of Parts 9, 10 and 11 of that National Instrument. Compliance with these requirements is the responsibility of the management of [name of mutual fund] (the "Fund"). Our responsibility is to express an opinion on management's compliance report based on our audit.

We conducted our audit in accordance with standards for assurance engagements set out in the CICA Handbook – Assurance. Those standards require that we plan and perform an audit to obtain reasonable assurance as a basis for our opinion. Such an audit includes examining, on a test basis, evidence supporting the assertions in management's compliance report.

In our opinion, the Fund's statement of compliance for the year ended [insert date] complies, in all material respects, with the applicable requirements of Parts 9, 10 and 11 of National Instrument 81102.

This report is provided solely for the purpose of assisting the securities regulatory authority [ies] to which it is addressed in discharging its [their] responsibilities and should not be used for any other purpose.

City
Date
Chartered Accountants

National Instrument 81-102

Appendix B-2

Compliance Report

TO: [The appropriate securities regulatory authorities]

FROM: [Name of principal distributor] (the "Distributor")

RE: Compliance Report on National Instrument 81-102 For the year ended [insert date]

FOR: [Name(s) of the mutual fund (the "Fund[s]")]

We hereby confirm that we have complied with the applicable requirements of Parts 9, 10 and 11 of National Instrument 81-102 in respect of the Fund[s] for the year ended [insert date] [except as follows:] [list exceptions, if any].

[NAME of the Distributor]

…….Signature
…….Name and office of the person executing this report
…….Date

National Instrument 81-102

Appendix B-2

Audit Report

TO: [The appropriate securities regulatory authorities]

RE: Compliance Report on National Instrument 81-102
For the year ended [insert date]

We have audited [name of principal distributor]'s report made under section 12.1 of National Instrument 81-102 regarding its compliance for the year ended [insert date] with the applicable requirements of Parts 9, 10 and 11 of that National Instrument in respect of the [name of mutual funds] (the "Funds"). Compliance with these requirements is the responsibility of the management of [name of principal distributor] (the "Company"). Our responsibility is to express an opinion on management's compliance report based on our audit.

We conducted our audit in accordance with standards for assurance engagements set out in the CICA Handbook – Assurance. Those standards require that we plan and perform an audit to obtain reasonable assurance as a basis for our opinion. Such an audit includes examining, on a test basis, evidence supporting the assertions in management's compliance report.

In our opinion, the Company's statement of compliance for the year ended [insert date] complies, in all material respects, with the applicable requirements of Parts 9, 10 and 11 of National Instrument 81-102 in respect of the Funds.

This report is provided solely for the purpose of assisting the securities regulatory authority [ies] to which it is addressed in discharging its [their] responsibilities and should not be used for any other purpose.

City
Date
Chartered Accountants

National Instrument 81-102

Appendix B-3

Compliance Report

TO: [The appropriate securities regulatory authorities]

FROM: [Name of participating dealer] (the "Distributor")

RE: Compliance Report on National Instrument 81-102 For the year ended [insert date]

We hereby confirm that we have sold mutual fund securities to which National Instrument 81-102 is applicable. In connection with our activities in distributing these securities, we have complied with the applicable requirements of Parts 9, 10 and 11 of National Instrument 81-102 for the year ended [insert date] [except as follows:] [list exceptions, if any].

[NAME of the Distributor]

…….Signature
…….Name and office of the person executing this report
…….Date

National Instrument 81-102

Appendix B-3

Audit Report

TO: [The appropriate securities regulatory authorities]

RE: Compliance Report on National Instrument 81-102
For the year ended [insert date]

We have audited [name of participating dealer]'s report made under section 12.1 of National Instrument 81-102 regarding its compliance for the year ended [insert date] with the applicable requirements of Parts 9, 10 and 11 of that National Instrument in respect of sales of mutual fund securities. Compliance with these requirements is the responsibility of the management of [name of participating dealer] (the "Company"). Our responsibility is to express an opinion on management's compliance report based on our audit.

We conducted our audit in accordance with standards for assurance engagements set out in the CICA Handbook – Assurance. Those standards require that we plan and perform an audit to obtain reasonable assurance as a basis for our opinion. Such an audit includes examining, on a test basis, evidence supporting the assertions in management's compliance report.

In our opinion, the Company's statement of compliance for the year ended [insert date] complies, in all material respects, with the applicable requirements of Parts 9, 10 and 11 of National Instrument 81-102 in respect of sales of mutual fund securities.

This report is provided solely for the purpose of assisting the securities regulatory authority [ies] to which it is addressed in discharging its [their] responsibilities and should not be used for any other purpose.

City
Date
Chartered Accountants

National Instrument 81-102

Appendix C

Provisions Contained in Securities Legislation for the Purpose of Subsection 4.1(5) – Prohibited Investments

Jurisdiction	**Securities Legislation Reference**
All Jurisdictions	s. 13.6 of National Instrument 31-103 *Registration Requirements, Exemptions and Ongoing Registrant Obligations*
Newfoundland and Labrador	s. 191 of Reg 805/96

Appendix D
Investment Fund Conflict of Interest Investment Restrictions

Jurisdiction	Securities Legislation Reference
All Jurisdictions	ss. 13.5(2)(a) and (b) of National Instrument 31-103 *Registration Requirements, Exemptions and Ongoing Registrant Obligations*
Alberta	ss. 185(2) and (3) of the *Securities Act* (Alberta)
British Columbia	s. 6(2) of BC Instrument 81-513 Self-Dealing
New Brunswick	s. 137(2) of the *Securities Act* (New Brunswick)
Newfoundland and Labrador	ss. 112(2), 112(3), 119(2)(a) and 119(2)(b) of the *Securities Act* (Newfoundland and Labrador)
Nova Scotia	ss. 119(2) and (3) of the *Securities Act* (Nova Scotia)
Ontario	ss. 111(2) and (3) of the *Securities Act* (Ontario)
Saskatchewan	ss. 120(2) and (3) of the *The Securities Act*, 1988 (Saskatchewan)

Appendix E
Investment Fund Conflict of Interest Reporting Requirements

Jurisdiction	**Securities Legislation Reference**
Alberta	s. 191(1)(a) of the *Securities Act* (Alberta)
British Columbia	s. 9(a) of BC Instrument 81-513 Self-Dealing
New Brunswick	s. 143(1)(a) of the *Securities Act* (New Brunswick)
Newfoundland and Labrador	s. 118(1)(a) of the *Securities Act* (Newfoundland and Labrador)
Nova Scotia	s. 125(1)(a) of the *Securities Act* (Nova Scotia)
Ontario	s. 117(1)(a) of the *Securities Act* (Ontario)
Saskatchewan	s. 126(1)(a) of the *The Securities Act*, 1988 (Saskatchewan).

Annex D-3

PROPOSED CHANGES TO
COMPANION POLICY 81-102CP TO
NATIONAL INSTRUMENT 81-102 *INVESTMENT FUNDS*

1. Companion Policy 81-102CP to National Instrument 81-102 Investment Funds is amended by this Document.

2. Part 2 is changed by adding the following sections:

2.01 "alternative funds" – The Instrument defines the term "alternative fund" as a mutual fund that has adopted fundamental investment objectives that permit it to invest in asset classes or adopt investment strategies that are otherwise prohibited but for prescribed exemptions from Part 2 of this Instrument. This generally refers to the ability to adopt higher concentration limits, invest in commodities, as well as employ leverage, through borrowing cash, selling securities short or by invest in specified derivatives. This term replaced the term "commodity pool" that was defined under the former National Instrument 81-104 *Commodity Pool* (NI 81-104), which has been repealed. The Canadian securities regulatory authorities will generally deem a mutual fund that was a commodity pool under NI 81-104 to be an alternative fund under this Instrument and will therefore be subject to the provisions in this Instrument applicable to alternative funds. This definition contemplates that the alternative fund's fundamental investment objectives will reflect those fundamental features that distinguish an alternative fund from other types of mutual funds. We would therefore expect that a "conventional" mutual fund that intends to become an alternative fund would need to amend its investment objectives to do so, which would require securityholder approval under Part 5 of the Instrument.

2.3.1 "cleared specified derivative" – the definition of "cleared specified derivative" is intended to apply to derivatives transactions that take place through the facilities of a clearing corporation, where that clearing corporation has been registered or authorized by one of the US Securities and Exchange Commission, the US Commodity Futures Trading Commission or the European Securities and Markets Authority, or is generally recognized as a clearing agency in Canada. This term is part of the codification of certain exemptive relief granted in connection with the adoption of the *Dodd-Frank Wall Street Reform and Consumer Protect Act* in the US and similar legislation in Europe (Dodd-Frank), which mandated that certain types of derivatives transactions be cleared through a clearing corporation registered or authorized by the applicable regulatory agency in the US or Europe. In practice, our expectation is that, given the global efforts to coordinate the clearing mandates of the Dodd-Frank legislation most clearing corporations in operation will be approved by more than one, if not each of the agencies referenced in that definition. The definition of cleared specified derivative in the Instrument does not refer only to those derivatives required to be cleared; it includes derivatives that are voluntarily cleared under the same infrastructure as those subject to mandatory clearing obligation. The Instrument provides exceptions from certain of the restrictions on specified derivatives transactions in section 2.7 for cleared specified derivatives transactions, in recognition of the mandates of the Dodd-Frank legislation,

including the protections and safeguards built into that clearing corporation infrastructure, consistent with the exemptive relief orders. **.**

3. Part 3 is changed by adding the following sections:

3.6.1 Cash Borrowing, Short Selling – (1) subsection 2.6(2), provides an exemption from the general prohibition on cash borrowing by investment funds, to allow alternative funds and non-redeemable investment funds to borrow up to 50% of their net asset value. This is to help facilitate the use of certain alternative strategies that require may require a fund to borrow cash. Borrowing under this provision will be subject to certain restrictions, including restrictions on persons or companies that may act as lenders. Specifically, a fund may only borrow cash from a lender that meets the criteria to qualify as a custodian or sub-custodian under section 6.2 of this Instrument, which is restricted to entities incorporated or registered in Canada. This may include a fund's own custodian or sub-custodian. However, if the proposed lender is an affiliate of the funds' investment fund manager, approval of the fund's independent review committee will be required as this will be viewed as a conflict of interest. Despite this, the Canadian securities regulatory authorities will generally expect that a fund will only seek to borrow from a lender that is an affiliate of the investment fund manager where it is clear that such as arrangement is in the investment fund's best interest, relative to the alternatives.

(2) For short-selling, section 2.6.1 permits alternative funds to exceed the limits on short-selling applicable to mutual funds generally and also exempts alternative funds from the restrictions on cash cover and using the proceeds from short sales to purchase long positions in a security. This is intended to facilitate the use of "long/short" strategies, which is a common strategy in the alternative fund space.

(3) Section 2.6.2 limits the use of these special exemptions for cash borrowing and short-selling by alternative funds, by imposing an overall combined cap on the use of these strategies to 50% of an alternative fund's net asset value. This reflects the view of the Canadian securities regulators that the special exemptions on the short-selling restrictions for alternative funds under section 2.6.1 are another means of facilitating borrowing by the fund. The intent is to limit overall borrowing by an alternative fund to 50% of NAV, whether it is through direct cash borrowing, short selling or a combination of both.

3.6.2 Total Leverage – Section 2.9.1 limits a fund's total exposure through borrowing, short selling or the use of specified derivatives to no more than 3 times the fund's net asset value. This overall limit is in addition to any specific limits applicable to borrowing, short-selling or specified derivatives transactions. For the purposes of the overall leverage limit, the fund's total exposure is to be calculated as the sum of the total amount of cash borrowed by the fund, the market value of all securities sold short, and the gross notional amount of its specified derivatives positions, in the latter case. The calculation of the specified derivatives positions does not allow for any offsetting of hedging transactions. It is intended to reflect a fund's total exposure to transactions that may create leverage, and is not necessarily intended as a measure of the fund's risk exposure. However, we do expect that the prospectus or other

disclosure documents of any investment fund that uses leverage will include specific disclosure concerning the risks associated with these strategies."

3.6.3 Notional Amount – Section 2.9.1 requires an investment fund to determine the notional amount of all of the fund's specified derivatives positions. The Canadian securities regulators are not mandating any specific method to calculate the notion amount of a specified derivative. However, we expect the investment fund to use generally recognized standards to determine the notional amount of a specified derivative and to apply the same methodology consistently when calculating its aggregate gross exposure or its net asset value**..**

4. This document become effective on •.

Annex E

PROPOSED AMENDMENTS TO
NATIONAL INSTRUMENT 81-106 *INVESTMENT FUND CONTINUOUS DISCLOSURE*

1. ***National Instrument 81-106 Investment Fund Continuous Disclosure is amended by this Instrument.***

2. ***Subsection 1.3(3) is amended by deleting "***National Instrument 81-104 *Commodity Pools or****" and by replacing "***those Instruments***" with "***that Instrument***".***

3. ***The Instrument is amended by adding the following section:***

3.12 Disclosure of Leverage - (1) An investment fund that uses leverage must disclose in its financial statements the lowest and highest level of leverage experienced by the investment fund in the reporting period covered by the financial statements, together with a brief explanation of the sources of leverage (e.g. borrowing, short selling or use of derivatives) used, how the investment fund calculates leverage as set out in section 2.9.1 of National Instrument 81-102 *Investments Funds* and the significance to the investment fund of the lowest and highest levels of leverage.

(2) The information required by subsection (1) may be included in the body of the financial statements or in the notes to the financial statements**..**

4. ***Form 81-106F1 Contents of Annual and Interim Management Report of Fund Performance is amended***

(a) in Item 2.3 of Part B by adding the following subsection:

(3) An investment fund that uses leverage must disclose,

(a) a brief explanation on the sources of leverage (e.g., borrowing, short selling, use of derivatives) used during the period;
(b) the lowest and highest level of leverage experienced during the period; and
(c) the significance of the lowest and highest levels of leverage to the investment fund***., and***

(b) by replacing the Instruction to Item 2.3 of Part B with the following:

INSTRUCTIONS:

(1) Explain the nature of and reasons for changes in the investment fund's performance. Do not simply disclose the amount of change in a financial statement item from period to period. Avoid the use of boilerplate language. Your discussion should assist the reader to understand the significant factors that have affected the investment fund's performance.

*(2) For the purposes of the disclosure required in Item 2.3(3), an investment fund's leverage must be calculated as set out in section 2.9.1 of National Instrument 81-102 Investment Funds.***.**

5. This Instrument comes into force on •.

Annex F

PROPOSED AMENDMENTS TO
NATIONAL INSTRUMENT 81-107 *INDEPENDENT REVIEW COMMITTEE FOR INVESTMENT FUNDS*

1. National Instrument 81-107 Independent Review Committee for Investment Funds is amended by this Instrument.

2. Subsection 5.2(1) is amended

(a) in paragraph (b) by deleting "or***",***

(b) in paragraph (c) replacing ".***" with "***; or***", and***

(c) by the adding the following paragraph:

(d) a transaction in which an investment fund intends to borrow cash from an entity described in paragraph 2.6(2)(b) of National Instrument 81-102 *Investment Funds*.**.**

3. Section 1 of the Commentary to Section 5.2 of the Instrument is changed by adding "or Part 2 and***" after "***Part 6 of this Instrument***" and by deleting "***or***" before "***Part 4 of NI 81-102***".***

4. This Instrument comes into force on •.

Annex G

PROPOSED AMENDMENTS TO
NATIONAL INSTRUMENT 81-101 *MUTUAL FUND PROSPECTUS DISCLOSURE*

1. National Instrument 81-101 Mutual Fund Prospectus Disclosure is amended by this Instrument.

2. Section 1.3 is amended by adding "or***" at the end of paragraph (a) and by repealing paragraph (b).***

3. Section 5.1 is amended by adding the following subsection:

(4) Despite subsection (1), a simplified prospectus for an alternative fund must not be consolidated with a simplified prospectus of another mutual fund other than an alternative fund.

4. Form 81-101F1 Contents of Simplified Prospectus is amended

(a) by adding the following under the general instructions:

*(14.1) Subsection 5.1(4) of NI 81-101 states that a simplified prospectus of an alternative fund must not be consolidated with a simplified prospectus of another mutual fund that is not an alternative fund.***,**

(b) by adding the following after Item 1.1(2) of Part A:

(2.1) If the mutual fund to which the simplified prospectus pertains is an alternative fund, indicate this on the front cover**.,**

(c) by adding the following after instruction (3) under Item 6 of Part B:

(4) If the mutual fund is an alternative fund, describe the asset classes that the mutual fund invests in or the investment strategies that the mutual fund follows that cause it to fall within the definition of "alternative fund" in NI 81-102. If those investment strategies involve the use of leverage, disclose the sources of leverage (e.g., borrowing, short selling, use of derivatives) as well as the maximum amount of leverage the alternative fund may use as a ratio calculated in accordance with section 2.9.1 of National Instrument 81-102 by dividing the sum of the following by the net asset value of the alternative fund:

(a) the aggregate value of the alternative fund's indebtedness under any borrowing agreements entered into by the fund;

(b) the aggregate market value of securities to be sold short by the alternative fund;

*(c) the aggregate notional amount of the alternative fund's exposure under its specified derivatives positions.***,**

(d) by adding the following after Item 7(10) of Part B:

(11) For an alternative fund that borrows cash under subsection 2.6 (2) of NI 81-102

(a) state that the alternative fund may borrow cash and the maximum amount the fund may borrow, and

(b) briefly describe how borrowing will be used in conjunction with other strategies of the alternative fund to achieve its investment objectives and the terms of the borrowing arrangements**.,**

(e) by adding the following after Item 9(2) of Part B:

(2.1) For an alternative fund, include disclosure to the effect that the alternative fund has the ability to invest in asset classes or use investment strategies that are not permitted for conventional mutual funds and explain how these investment strategies may affect investors' chance of losing money on their investment in the fund**.,**

(f) by deleting "and***" at the end of paragraph (b) of Item 9(7) of Part B,***

(g) by replacing "." *at the end of paragraph (c) of Item 9(7) of Part B with "*; and***",***

(h) by adding the following after paragraph (c) of Item 9(7) of Part B:

(d) borrowing arrangements**..**

5. Form 81-101F2 Contents of Annual Information Form is amended

(a) by adding the following after Item 1.1(2):

(2.1) If the mutual fund to which the annual information form pertains is an alternative fund, indicate this on the front cover**.,**

(b) by adding the following after Item 10.9.1

10.9.2 Lender

(1) State the name of each person or company that has lent money to the alternative fund.

(2) State whether any person or company that has lent money to the alternative fund is an affiliate or associate of the manager of the alternative fund**..**

6. Form 81-101F3 Contents of Fund Facts Document is amended

(a) by adding the following after paragraph (f) of Item 1 of Part I:

(g) if the fund facts document pertains to an alternative fund, textbox disclosure using wording substantially similar to the following:

This mutual fund is an alternative fund. It has the ability to invest in asset classes or use investment strategies that are not permitted for conventional mutual funds.

The specific strategies that differentiate this fund from conventional mutual funds include: [list the asset classes the alternative fund invests in and/or the investment strategies used by the alternative fund that cause it to fall within the definition of "alternative fund" in NI 81-102].

[Explain how the listed investment strategies may affect investors' chance of losing money on their investment in the alternative fund.]**,**

Note: The CSA is currently working on the development of an ETF Facts for exchange traded mutual funds. We anticipate including a similar disclosure requirement in Form 41-101F4.

(b) by replacing the Instruction under Item 1 of Part I with the following:

INSTRUCTIONS:

(1) The date for a fund facts document that is filed with a preliminary simplified prospectus or simplified prospectus must be the date of the certificate contained in the related annual information form. The date for a fund facts document that is filed with a pro forma simplified prospectus must be the date of the anticipated simplified prospectus. The date for an amended fund facts document must be the date of the certificate contained in the related amended annual information form.

(2) If the fund facts document pertains to an alternative fund that uses leverage, the required textbox disclosure must disclose the sources of leverage. It must also disclose the maximum amount of leverage the alternative fund may use, along with the minimum and maximum amount of leverage experienced by the alternative fund as disclosed in the most recently filed interim financial reports and audited financial statements. For a newly established alternative that has not yet filed any financial statements, state the expected range of leverage.

(3) Leverage must be disclosed as a ratio calculated by dividing the sum of the following by the net asset value of the alternative fund:

(a) the aggregate value of the alternative fund's indebtedness under any borrowing agreements entered into by the fund;

(b) the aggregate market value of securities to be sold short by the alternative fund;

(c) *the aggregate notional amount of the alternative fund's exposure under its specified derivatives transactions.***.**

Note: The CSA is currently working on the development of an ETF Facts for exchange traded mutual funds. We anticipate including a similar instructions in Form 41-101F4.

7. This Instrument comes into force on ●.

Annex H

PROPOSED AMENDMENTS TO
NATIONAL INSTRUMENT 41-101 GENERAL PROSPECTUS REQUIREMENTS

1. National Instrument 41-101 General Prospectus Requirements is amended by this Instrument.

2. Form 41-101F2 Information Contained in an Investment Fund Prospectus is amended

(a) by replacing "commodity pool***" in Item 1.3(1) with "***alternative fund***",***

(b) by adding the following after Item 1.3(3)

(4) If the mutual fund to which the prospectus pertains is an alternative fund, include a statement explaining that the fund has the ability to invest in asset classes or use investment strategies that are not permitted for conventional mutual funds and explain how exposure to such asset classes or the adoption of such investment strategies may affect investors' chance of losing money on their investment in the fund.**,**

(c) by repealing Item 1.12,

(d) by replacing paragraph (e) of Item 3.3(1) with the following:

(e) the use of leverage, including the following:

(i) the maximum amount of leverage the investment fund may use as a ratio calculated in accordance with section 2.9.1 of National Instrument 81-102 by dividing the sum of the following by the net asset value of the alternative fund:

(A) the aggregate value of the investment funds' indebtedness under any borrowing agreements entered into by the fund;

(B) the aggregate market value of securities to be sold short by the investment fund;

(C) the aggregate notional amount of the investment fund's exposure under its specified derivatives transactions,

(ii) any restrictions on the leverage used or to be used by the investment fund, and

(iii) a brief explanation of any maximum or minimum limits that apply to each source of leverage.

(e) by adding the following after instruction (3) under Item 5:

(4) If the mutual fund is an alternative fund, describe the asset classes that the mutual fund invests in or the investment strategies that the mutual fund follows that cause it to fall within the definition of "alternative fund" in NI 81-102. If those investment strategies involve the use of leverage, disclose the sources of leverage (e.g., borrowing, short selling, use of derivatives) as well as the maximum amount of leverage the alternative fund may use as a ratio calculated in accordance with section 2.9.1 of National Instrument 81-102 by dividing the sum of the following by the net asset value of the alternative fund:

(a) the aggregate value of the alternative fund's indebtedness under any borrowing agreements entered into by the fund;

(b) the aggregate market value of securities to be sold short by the alternative fund;

*(c) the aggregate notional amount of the alternative fund's exposure under its specified derivatives transactions.***,**

(f) by replacing paragraph (b) of Item 6.1(1) with the following:

(b) the use of leverage, including the following:

(i) any restrictions on the leverage used or to be used by the investment fund, and

(ii) a brief explanation of any maximum and minimum limits that apply to amounts of leverage to the investment fund.

(g) by adding the following after Item 6.1(6):

(7) For an alternative fund that borrows cash under subsection 2.6 (2) of National Instrument 81-102 *Investment Funds*,

(c) state that the alternative fund may borrow cash and the maximum amount the fund may borrow, and

(d) briefly describe how borrowing will be used in conjunction with other strategies of the alternative fund to achieve its investment objectives and the terms of the borrowing arrangements**.,**

(h) by adding the following after Item 19.11

19.12 Lender

(3) State the name of each person or company that has lent money to the investment fund.

(4) State whether any person or company that has lent money to the investment fund is an affiliate or associate of the manager of the investment fund**..**

3. This Instrument comes into force on ●.

Annex I

LOCAL MATTERS

Specific Question of the Alberta Securities Commission relating to the Proposed Amendments

A number of the proposed amendments have the effect of liberalizing current restrictions applicable to commodity pools, on one hand providing investors in alternative funds with potentially more investment options but on the other hand providing investors with the potential to increase risks in respect of those investments. Having regard to the disclosure provided to investors respecting investment strategies, suitability and risks, do the proposed amendments make clear the potential for greater risk and strike the right investor protection balance?

INCLUDES COMMENT LETTERS

December 12, 2016

To: 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 & Consumer 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
Superintendent of Securities, Northwest Territories
Superintendent of Securities, Yukon
Superintendent of Securities, Nunavut

The Secretary Ontario Securities Commission: Email: comments@osc.gov.on.ca

Me Anne-Marie Beaudoin
Directrice du secrétariat, Autorité des marchés financiers
Email: consultation-en-cours@lautorite.qc.ca

Re: Amendments to NI81-102 and NI81-104

The Canadian Securities Institute (CSI) welcomes the opportunity to submit the following remarks in response to the CSA's September 22, 2016 request for comments on the Modernization of Investment Fund Product Regulation – Alternative Funds.

CSI is the leading provider of accredited financial services proficiency learning solutions in Canada. We are IIROC's primary proficiency partner and in collaboration with IIROC offer the courses and examinations that comprise the most extensive and robust proficiency regime for financial services advisors in Canada. Our financial services courses are the most popular educational routes chosen by candidates seeking certification, licensing and professional designations in financial services.

We will focus our comments on proficiency standards for representatives dealing in alternative funds.

We agree with the proposal to remove the proficiency requirements from the regulations dealing specifically with alternative funds. We also agree that the proficiency requirements for alternative funds should be incorporated within National Instrument 31-102 and the "know your product rules" of the appropriate SROs, such as the MFDA.

Due to the complex nature of alternative investments, we recommend that mutual fund dealing representatives be subject to a proficiency requirement for trading in these products. Furthermore, this requirement should sit as a top-up rather than it being included in the base mutual fund licencing examination. The introduction of an additional proficiency level is the most appropriate solution given many financial institutions have restrictions on the types of investments that representatives can offer to clients. For example, a mutual fund sales representative in a bank branch is not likely to have the authority to offer alternative investments given the general sophistication level of clients they deal with on a daily basis. Given

the complexity of alternative funds adding this content to the base licensing exam could significantly divert focus and examination weighting away from the more relevant areas of proficiency.

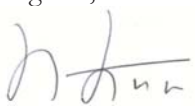
As their client base changes, advisors will be provided with the opportunity to upgrade their proficiency from the base requirements – similar to the requirements likely to be implemented by the MFDA for advising on Exchange Traded Funds. To provide the regulator with more insight into the possible content required for a top-up course on alternative investments, we have prepared an outline and included it as Appendix 1 to this comment letter.

However, should the regulator decide to raise the base proficiency level to include Alternative Investments, it would be appropriate for all individuals currently registered as a dealing representative to be subject to a top-up course on alternative funds to ensure all representatives are operating at the same level of proficiency when dealing with the public. The exception to the rule will be those dealing representatives who met their minimum proficiency licensing requirements through completion of the Canadian Securities Course (CSC), where alternative funds are well covered. For this reason IIROC representatives, would not be subject to this additional proficiency requirement.

To ensure that all dealing representatives looking to sell Alternative Funds have the same level of proficiency we suggest that the required course and examination content for proficiency in alternative funds be developed and validated by the industry in collaboration with the SROs, the CSA and proficiency providers. As a result of this effort, courses that currently meet the proficiency requirements, would be reviewed to ensure they cover all of the required concepts sufficiently. CSI would be pleased to participate in such a project.

Please contact me if you have any questions.

Regards,



Marc Flynn
Sr. Director
Regulatory Relations and Credentialing
Canadian Securities Institute
Moody's Analytics

cc: Debbie Bell, Associate Director, Regulatory & Credentialing

Appendix 1
Possible Curriculum Content for Alternative Funds

Chapter #	Chapter Heading	Details
1.	Overview of Alternative Funds	What is an alternative investment fund?
		Size of the Market
		Alternative Fund Strategies
		Capacity constraints
		Regulatory landscape
		Reduced disclosure
		Tax implications
		Alternative Features
		Historical Performance
		Business risk
2.	Overview of Derivatives	Introduction
		What Is a Derivative?
		Features Common to All Derivatives
		Derivative Markets
		Key Differences between Exchange-traded and OTC Derivatives
		Types of Derivatives
		Forward Agreements
		Futures Contracts
		Swaps
		Option-Based Derivatives
		Option Premiums
		Offset, Exercise, Assignment, and Being "In-the-Money"
		Exotic Options
		Key Differences between Forward-Based and Option-Based Derivatives
		Underlying Assets
		Financials
		Interest Rates
		Other Underlying Assets
3.	Alternative Fund Strategies	Relative Value
		Event Driven
		Directional
4.	Risk Drivers	Three kinds of risk drivers
		First order risks
		Second order risks
		Operational risks
5.	Funds of Funds	The role of the fund of funds manager
		Diversification
		Advantages and Disadvantages

Chapter #	Chapter Heading	Details
6.	Principal Protected Notes	What are Hedge Fund linked notes
		Zero Coupon + Call option structure
		CPPI Structure
		Costs
		PPN Risks
		Choosing a PPN
7.	How Alternative Funds and Mutual Funds Use Derivatives Within Regulatory Bounds	Regulatory Restrictions on the use of derivatives may mutual funds NI81-102
		Hedging techniques
		Non-hedging strategies
		How Hedge Funds can use derivatives
8.	Incorporating Alternative Funds into a Portfolio	Investor Suitability
		Asset Allocation and Hedge Funds
		Using Mean-variance optimization with hedge funds
		Hedge Funds as a separate asset class or integrated with other asset classes
9.	Due Diligence When Investing in Alternative Funds	Who performs due diligence
		Key due diligence areas
		A comprehensive due diligence process
10.	Performance Appraisal	Performance Measures
		Return Measures
		Risk Measures
		Risk Adjusted Returns
		Value at Risk
		Limitations of Quantatative Risks
11.	Regulatory Issues Pertaining to Investing in Alternative Funds	Prospectus Requirements and Prospectus-Exempt Distributions Applicable to Hedge Funds
		Legal Structures for Hedge Funds in Canada
		Securities Regulations Applicable to Hedge Funds
12.	Alternative Fund Service Providers	Prime Broker
		Custodian
		Fund Administrator
		Accounting Firm
		Legal Advisor
		Tracing the Flow of Money

Kenmar Associates
Investor Education and Protection

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December 12, 2016

Me Anne-Marie Beaudoin
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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

CSA Notice and Request for Comment - Modernization of Investment Fund Product Regulation - AlternativeFunds

http://www.osc.gov.on.ca/en/SecuritiesLaw_ni_20160922_81-101-81-102_rfc-modernization-ifpr-alternative-funds.htm

We came upon this consultation by chance. Given the short time remaining for comments we provide an abbreviated set of comments focused on mutual funds. Kenmar is pleased to offer comments on the proposed amendments for alternative mutual funds.

On September 22, 2016, the Canadian Securities Administrators (CSA) published *Notice and Request for Comment — Modernization of Investment Fund Product Regulation —*

Alternative Funds (the Proposal). The Proposal introduces a framework for offering retail investors access to "alternative funds" (commonly known as hedge funds) through a series of amendments to *National Instrument 81-102 Investment Funds* (NI 81-102), which currently governs all publicly offered mutual funds and non-redeemable investment funds in Canada. The Proposal would permit hedge fund managers to offer alternative funds to the retail market through a long-form prospectus offering.

The Proposal, while focused on alternative funds, also includes provisions that will impact other types of mutual funds (namely conventional mutual funds and exchange-traded funds), as well as non-redeemable investment funds, through changes to the investment restrictions in NI 81-102 relating to investments in physical commodities, other investment funds and illiquid assets. Under the Proposal, *National Instrument 81-104 – Commodity Pools* (NI 81-104) — which governs commodity funds like gold or precious metal funds — would be repealed as these types of funds would now be governed by NI 81-102. The Proposal provides a six-month transition period for existing investment funds to comply with the changes which appears to be adequate.

The Proposal suggests aggregate leverage metrics for alternative funds, while seeking further input regarding how leverage should be calculated. For example, the Proposal establishes a cap for ALTs on aggregate short selling and cash borrowing of 50% of NAV at any time, and a cap on aggregate gross exposure through borrowing, short selling and the use of specified derivatives, of three times NAV, including hedging transactions. The CSA solicits comment on whether offsetting or hedging transactions should be permitted to reduce calculated leverage, and whether there are better ways to calculate leverage which more accurately reflect a fund's risk exposure. We do not have the resources at this time to offer much assistance in this area.

The Proposal does not set any limits for ALTs to trade in "cleared specified derivatives" registered with a regulated clearing agency in Canada, the United States, or Europe. Further, there are no restrictions on the type of counterparty with which an alternative fund may trade in over-the-counter derivatives, provided that marked-to market exposure to any one counter-party is capped at 10% of NAV.

The Proposal subjects ALTs to the same restrictions on fund-on-fund investing that apply to mutual funds, including that the underlying fund(s) must comply with National Instrument NI 81-102 and be a reporting issuer in the jurisdiction. These restrictions would preclude alternative funds from investing in foreign or private hedge funds.

The Consultation states:" The Proposed Amendments would enhance the offering of alternative funds and strategies by setting an appropriate regulatory framework in which these strategies may be used in funds sold by prospectus. We think that not proceeding with the Proposed Amendments would stifle innovation in the marketplace to the detriment of both investors and the investment funds industry." The CSA may be right about the investment industry but it is our experience that complex products and other industry "innovations" have caused much investor harm . Think LSIF's. Non-bank ABCP , leveraged ETF's , structured products etc. We believe the contrary – Main Street needs simple low-cost solutions, not ones so complex ,they are not understood. There already is a bewildering array of expensive products to choose from. See **The Growing Pains of**

the Liquid Alt Market (U.S.) "These products in general were supposed to offer diversification away from traditional stock and bond strategies, and perform better when the market lagged, and what we've seen in the last couple of years, when the market's been flat or down, these products have lost money also, on average," Rosenbluth said." http://www.wealthmanagement.com/alternative-investments/growing-pains-liquid-alt-market

Investment restrictions applicable to ALTs

The Proposal provides some latitude for alternative funds to engage in the investment strategies which they currently use in the exempt market. Per our understanding , the following table sets out the proposed differences in the key investment restrictions applicable to mutual funds and ALTs:

	Mutual Funds	ALTs
Concentration restriction	No more than 10% of net asset value (NAV) invested in securities of any one issuer	No more than 20% of NAV invested in securities of any one issuer
Investments in illiquid assets	No more than 10% of NAV at time of purchase No more than 15% of NAV for 90 days or more	No more than 10%* of NAV at time of purchase No more than 15%* of NAV for 90 days or more
Borrowing	5% of NAV at time of borrowing, for limited purposes	50% of NAV for all purposes including portfolio investments
Short selling	No more than 5% of NAV in one issuer No more than 20% of NAV total shorts	No more than 10% of NAV in one issuer No more than 50% of NAV total shorts

- The CSA is considering whether to permit ALTs to invest a greater percentage of NAV in illiquid assets, understanding that this will impact the frequency of redemptions .

Alt Mutual funds will no longer be prohibited from indirect exposure to physical commodities through specified derivatives and direct investment in silver, platinum, and palladium will no longer be prohibited – ie they will be allowed in addition to gold (including certificates representing these precious metals) .

Closed-end funds, which currently have no concentration restrictions, would also be

subject to a 20% limit under the Proposal.

The CSA notes that many of the Proposed Amendments codify exemptive relief routinely granted, or expand prevailing investment parameters and limits currently applicable to mutual funds and commodity pools. Routine exemptive relief by regulators is a separate issue that concerns us ,but we leave that for another time.

Alternative funds (ALTS)

We define Alternative funds (ALTs) as funds that use strategies that are not generally permissible for retail mutual funds, such as short-selling, borrowing, investing in illiquid assets and taking concentrated positions in a small number of issuers. As a result, ALTs do not typically provide daily liquidity. Rather, investments are often subject to an initial lock-up period (one to two years is common), and after that, ALTs may offer monthly or quarterly redemptions, in some cases subject to a "gate" (which is a limitation expressed as a percentage of the investment which may be redeemed as of each redemption date).

Because of their complex strategies and limited liquidity, ALTs have historically been considered too risky and complex for retail investors, in contrast to traditional, plain vanilla mutual funds, which maintain generally diverse, long-only portfolios of publicly traded securities and provide daily liquidity. ALTs have been the domain of sophisticated institutional investors/individuals which could bear the loss of their entire investment, and did not need immediate access to invested funds. Despite mixed results, industry participants and securities regulators believe that ALT mutual funds can play a risk management role in investment portfolios by providing exposure to non-traditional asset classes and using hedging strategies which seek to be uncorrelated to equity market returns. Given prevailing market volatility, low interest rates and forecasted low market returns ,we can understand why this issue is being raised. That being said ,we do not believe the current rules and prevailing industry professional advice practices will be able to safely distribute ALT mutual funds to retail mutual fund investors.

MAIN CONCERNS

1. **Training/Proficiency** Kenmar has issued numerous reports on leveraged, inverse and commodity ETFs which called on regulators to protect retail investors from these potentially harmful financial products that were not suitable as buy and hold investments, whether in an RRSP/RRIF or other investment portfolio. In June 2009, IIROC issued a guidance note for its dealer members on their duties with respect to these complex products and some retail firms chose to prohibit their "advisors" from selling these products to retail .FINRA, in the United States, also issued a Regulatory Notice on leveraged and inverse exchange-traded funds. Despite these warnings about the potential hazards in these complex products, there continue to be disciplinary cases and complaints before the Ombudsman for Banking Services and Investments ("OBSI") where these ETFs have been sold to retail investors for whom they were not suitable. We attribute the mis-selling to inadequate training of dealing reps. Given this history , we believe a similar

situation can develop with ALT's especially in the MFDA channel where proficiency requirements are lower than the IIROC channel. In our opinion, specific training would be necessary for an individual IIROC or MFDA dealing representative to understand the structure, features, risks and suitability of any alternative mutual fund securities that he or she may recommend within the context of a portfolio. Evidence of successful completion of this training should be retained in personnel records.

2. **KYC Process** SIPA has issued a report on the fundamental weakness of the KYC process in practice. Until these deficiencies are cleaned up , we believe retail investors would be in harms way if exposed to ALT' mutual funds.
3. **Risk Profiling** A 2015 OSC IAP sponsored report on Risk profiling by PlanPlus revealed that the vast majority of profiling processes in use were unfit for purpose. Given the sheer complexity of ALT mutual funds, we question the wisdom of exposing mutual fund investors to these products under these conditions.
4. A**dvice standard** We do not believe that the suitability standard is adequate to provide trusted investment advice for Alt mutual funds. Kenmar recommend that a Best interests or fiduciary standard be necessary when recommending Alt funds for a portfolio.

We would not expect such a product to be sold on a DSC basis

In 2013 FINRA issued an investor ALERT **Alternative Funds Are Not Your Typical Mutual Funds** advising retail investor's of the risks associated with Alt mutual funds. http://www.finra.org/investors/alerts/alternative-funds-are-not-your-typical-mutual-funds Although the strategies and investments of alt funds may bring to mind those of hedge funds, the two should not be confused. Retail investors should be informed that alternative mutual funds are regulated under mutual fund provisions , which limits their operations in ways that do not apply to what are commonly referred to as hedge funds.

Relationship with current and proposed suitability obligations

The Proposal seeks comment regarding what types of enhanced proficiency requirements ought to apply to dealing representatives that sell alternative funds. The CSA states that it is working with the Mutual Fund Dealers Association (MFDA) on this issue, but it does not purport to interfere with the current requirements applicable to dealing representatives that sell hedge funds on the platform of the Investment Industry Regulatory Organization of Canada (IIROC). Dealing Reps will not only have to comply with KYP , they will have to figure out how to integrate ALT mutual funds into a portfolio to meet client objectives, no easy task . See **Liquid Alternatives: Considerations for Portfolio Implementation** | PIMCO https://www.pimco.com/insights/viewpoints/in-depth/liquid-alternatives-considerations-for-portfolio-implementation

Even with additional education and training, it will still be difficult for dealers to develop and apply a uniform set of know-your-client (KYC) and know-your-product (KYP) criteria when determining the suitability of an alternative mutual fund for a client’s portfolio. ALT

strategies are complex and have traditionally been perceived as more risky. Given their unique risk profile, the basic risk tolerance scale included on most KYC forms is unlikely to be adequate. In addition, although ALTs are being grouped together as an asset class for the purposes of the Proposal, their investment objectives, strategies and underlying investment portfolios are very diverse. Ongoing consideration of macro market factors as well as individual client circumstances will be necessary when determining the suitability of an alternative fund or strategy.

While improved disclosure and oversight of the sales process (to ensure suitability) have been the focus of regulators in the past, many leading jurisdictions are moving beyond this approach and are intervening at an earlier stage to ensure that new products serve the needs of the client base to whom they are marketed. When seeking to address the KYC, KYP and suitability challenges posed by alternative funds, IIROC and MFDA members will be cognizant of the proposed targeted reforms to these requirements set out in *CSA Consultation Paper 33-404*: *Proposals to Enhance the Obligations of Advisers, Dealers and Representatives Toward their Clients*. That consultation paper introduces new guidelines for dealers when constructing their approved product lists which are designed to give investors access to a range of suitable investments, including by conducting a fair and unbiased market investigation, product comparison and product optimization analysis based on client needs and objectives. Faced with these new requirements relating to their existing product line-ups, the Proposal , if adopted,may constrain broad exposure of the new ALT asset class to the retail investing public.

Investor protections

While the Proposal offers ALTs the freedom to pursue non-traditional investment strategies, it imposes the same core investor protection requirements that apply to all publicly offered investment funds. Alternative funds will be required to file a prospectus and publish the Fund Facts point-of-sale document in the prescribed form. These disclosure standards are higher than the unregulated offering memoranda and investor presentations under which hedge funds are offered in the exempt market. While many Canadian-domiciled private hedge funds already comply with requirements to prepare audited annual financial statements and unaudited semi-annual financial statements, ALTs will need to make these statements publicly available, including Statements of Investment Portfolio, which provide position level transparency.

In addition, ALTs will need to provide security-holder approval rights for certain fundamental changes and comply with the related meeting and disclosure requirements, as well as the restrictions on sales communications and prohibited representations which apply to mutual funds. Although these investor protections will impose incremental regulatory obligations on hedge fund managers, we do not believe that many Canadian managers will have the compliance resources to address these requirements even though they are already subject to the advisor and investment fund manager registration regime. The recent CIBC (and other) double dipping scandal have revealed jut how weak contemporary compliance and internal audit regimes are.

We note that Alt mutual funds will be subject to NI81-105 Mutual Fund Sales Practices.

Our concern here is that there does not appear to be any enforcement of the provisions of this National Instrument.

Nomenclature : Kenmar believes that better nomenclature /labelling in the name of the investment fund of the heightened risk and complexity along with more robust regulation and enforcement of misleading advertising, coupled with a Best interest standard, would go a long way to helping to protect investors. The category "alternative" is meaningless to the average retail investor regarding the level of risk and complexity that is associated with ALT mutual funds. The word "alternative" does not convey anything of particular importance to the average retail investor and therefore would not alert him/her of the risks involved. We think the term " non-conventional mutual fund" would prompt most retail investors to ask questions. There may be a need for some focus group testing.

Borrowing : Unless there is good reason, we would suggest that alternative funds not be permitted to borrow from entities other than those that meet the definition of a custodian for investment fund assets in Canada. We cannot comment if this requirement would unduly limit the access to borrowing for investment funds . We agree that where the lender is an affiliate of the alternative fund's investment manager, approval of the fund's independent review committee ("IRC") would be required under National Instrument 81-107 Independent Review Committee for Investment Funds ("NI81-107"). The Proposal specifies that any borrowing agreements entered into must be in accordance with normal industry practice and be on standard commercial terms for agreements of this nature- this makes good business sense.

Dependence on disclosure: While disclosure is a necessary aspect of securities regulation, it has been documented that it alone will not provide adequate protection to retail The provision of long, detailed lists of material facts in lengthy, complex and legalistic documents will not serve to protect retail investors in the absence of further fundamental reforms. However, whatever summary method of disclosure is used we expect more attention should be paid to risk disclosure, redemption constraints and taxation than in the current FF's.

Performance fees: Fee disclosure including any performance provisions would have to be made crystal clear. Unlike conventional mutual funds, which can only charge performance fees tied to a reference benchmark or index, alternative funds may charge performance fees based on the total return of the fund itself. Performance fees are required to be subject to a high water mark. Currently, many private hedge funds will reset their high water mark either on a regular basis (e.g. annually) or upon the occurrence of certain events (e.g. a recession with a specified number of quarters with negative returns). There is no apparent mechanism for a "reset" of the high water mark contemplated in the Proposal.

Risk disclosure : Kenmar do not agree that the use of volatility is a useful way to describe risk to retail investors. Kenmar would strenuously object if anything similar to the deceptive risk disclosure (actually volatility) in Fund Facts were utilized for Alt mutual funds. We believe the strategy and principal risks of the fund have to be revealed in plain language (Grade 6 reading level).

Fund purity : Under the proposal conventional mutual funds would be able to invest up to 10% of their NAV in alternative funds and non-redeemable funds that are subject to NI 81-102 (which excludes privately offered funds). We feel this will make it much harder for retail investors to use basic asset allocation principles in constructing their portfolios. It will also further make the use of the standard deviation as a risk rating indicator even more preposterous. We recommend that fund purity be maintained.

Fund governance: As to fund governance, it remains an open question whether NI81-107 provisions will be adequate for these complex funds. This would require considerable analysis and reflection.

Retail investors should be provided with an information brochure and website materials by the CSA describing all aspects of alternative mutual funds in plain language so they better understand what they are getting involved with. See http://www.investopedia.com/articles/financial-theory/08/alternative-assets.asp as an example.

We sincerely hope this feedback is useful to the CSA.

If there are any questions , do not hesitate to contact us.

Permission is granted for public posting of this Comment letter

Ken Kivenko P.Eng.

President, Kenmar Associates

REFERENCES

Guide to sound practices for disclosure and promotion of alternative investments :AIMA
http://www.aima.org/filemanager/root/site_assets/canada/publications/AIMA_Disclosure_Promotion-June14Final.pdf

Liquid alternative mutual funds
https://www.sec.gov/comments/s7-24-15/s72415-96.pdf

SEC Examine Alt Mutual Fund alert
In January 2014 , the SEC issued a risk alert
https://www.sec.gov/about/offices/ocie/adviser-due-diligence-alternative-investments.pdf
to investment advisors urging them to take extra care with regard to their due diligence efforts on alternative investments. While that statement did not specifically mention alternative mutual funds, it was clear that advisors need to have specific policies in place for conducting research on the full range of alternative investments, and to clearly communicate with their clients the methods they used to perform their due diligence.

https://dailyalts.com/sec-examine-alternative-mutual-funds/

Canadian open end mutual funds :Potential vulnerabilities: BofC
http://www.bankofcanada.ca/wp-content/uploads/2015/06/fsr-june15-ramirez.pdf

A New Framework for Analyzing Alternative Mutual Funds : Morningstar
http://news.morningstar.com/articlenet/article.aspx?id=774830

Liquid alternative mutual funds leave investors disappointed :FT
https://www.ft.com/content/a485f82e-1d18-11e6-a7bc-ee846770ec15

The Success and Dangers of 'Liquid Alternative' Mutual Funds – WSJ
http://www.wsj.com/articles/the-success-and-dangers-of-liquid-alternative-mutual-funds-1428375823

Alternative Funds Are Not Your Typical Mutual Funds | FINRA.org
http://www.finra.org/investors/alerts/alternative-funds-are-not-your-typical-mutual-funds

Alternative Mutual Funds: New Risks in the New Innovation :: TabbFORUM - Where Capital Markets Speak
Adequacy of returns could potentially be the biggest source of disappointment for the retail investors when benchmarking liquid alternative returns with the headline returns associated with broader private hedge fund indices. There may be divergence in performance. A better benchmarking for liquid alternative products would be comparing risk- adjusted return or Sharpe ratio with long-only products.
http://tabbforum.com/opinions/alternative-mutual-funds-new-risks-in-the-new-innovation

Unconstrained Mutual Funds and Retail Investor Protection July 19, 2016
Abstract: The proliferation of unconstrained mutual funds calls into question the effectiveness of retail investor protections under the Investment Company Act of 1940. Analyzing trading data and prospectuses of a hand-selected sample of all unconstrained mutual funds launched from 2010 through 2015 (N=449), the authors provide an overview of the evolution of unconstrained mutual funds, contrasting core characteristics with publicly available data pertaining to benchmarked mutual fund investment indices. The article demonstrates that unconstrained mutual funds share multiple investment strategy and risk attributes with fixed income hedge funds. The authors evaluate associated investor protection concerns.
https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2811729

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16 December 2016

We thank the CSA for the opportunity to provide comments on the proposed changes to NI 81-102 Investment Funds. Lightwater Partners Ltd. is an alternative asset manager based in Toronto. The firm was founded in 2007 and is registered with the Ontario Securities Commission as a Portfolio Manager, Investment Fund Manager, and Exempt Market Dealer.

Background

> "The Proposed Amendments are part of the CSA's implementation of the Modernization Project."

Comment: As part of its "modernization project" the CSA should fundamentally reconsider its approach to regulation. Risk should not be judged on *how* a security or fund is distributed; risk should be judged on *what* is being distributed. The prevailing CSA notion that a prospectus offering is inherently less risky than an Offering Memorandum product is an outdated concept. The $112 billion dollars lost by Valeant shareholders over the last 15 months is a stark reminder of this point.

Fund-of-Fund Structures

> "We are proposing to permit mutual funds (other than alternative funds) to invest up to 10% of their net assets in securities of alternative funds and non-redeemable investment funds, provided those underlying funds are subject to NI 81-102."

Comment: Mutual funds are managed by sophisticated professionals who are skilled in assessing risk. These professional Portfolio Managers do not need the same protections that may apply to retail investors. Hence, Portfolio Managers should be able to invest in non-NI 81-102 compliant funds.

Further, we do not understand the logic of restricting such investments at 10% of NAV. Given that risk analysis, measurement and assessment are fundamental competencies of Portfolio Managers in Canada, there is no reason why a Portfolio Manager should not have the option to put up to 100% of a portfolio in investment funds. To impose a "bright line" standard of a 10% investment limit is both arbitrary and unduly restrictive.

Short Selling

"We are proposing to increase the aggregate market value of all securities that may be sold short by an alternative fund to 50% of the NAV of the fund."

Comment: Liquid alts are designed to bring alternatives to retail investors in a lower risk manner. By limiting short selling at 50% of NAV, the CSA would effectively increase the level of risk in most long/short portfolio strategies – particularly for market-neutral positions, which are one of the most conservative investment strategies. It is ironic that the outcome of the proposal would be the unintended (and unfortunate) consequence that underlying hedge funds would have a lower risk profile than their liquid alt equivalents, even though the former is automatically classified as high risk. We recommend that this limit not be applied to such funds.

"We are also proposing to increase the aggregate market value of all securities of any issuer that may be sold short by an alternative fund to 10% of the NAV of the fund."

Comment: The CSA proposes to limit short selling at 50% of NAV yet it is willing to allow up to 10% in one short position? Clearly the CSA has little understanding of risk management in a long/short portfolio. This is particularly alarming given that a sizeable portion of the mutual fund Portfolio Managers who may be managing these new alternative funds will have little or no experience in short-selling securities.

Disclosure / Short Selling

"A key element of the CSA's proposal for a more robust framework for alternative funds is to also bring alternative funds into the prospectus regime that exists for other types of mutual funds. Currently, under NI 81-101, all mutual funds, other than commodity pools and exchange listed mutual funds, are required to prepare an SP, annual information form (AIF) and Fund Facts, with the Fund Facts having to be delivered at or before the point of sale. We are proposing that alternative funds that are not listed on an exchange be subject to this disclosure regime."

Comment: These disclosure proposals seem oblivious to the dangers of disclosing short positions. Unlike a short 'attack' on a security, which is limited by a short-seller's ability to borrow for a stock and to pay stock lending fees, there are no such limitations for a short squeeze. Once other investors become aware of short positions, the danger of a short squeeze is ever-present. This is one of the main reasons why liquid alts have failed to replicate the success of their hedge fund counterparts in Europe and the USA.

Form of Prospectus/Point of Sale

> "Given the CSA's efforts to otherwise harmonize the disclosure regimes for mutual funds, we do not believe that there is a policy basis for requiring that unlisted alternative funds continue to be subject to a different prospectus regime than every other type of unlisted mutual fund."

Comment: This is an ominous statement concerning the future of the Exempt Market in Canada. Liquid alts are at best a second-rate substitute for hedge funds. It is ironic that to meet the criteria proposed in NI 81-102 we would have to increase the level of risk and reduce the expected return of our hedge funds.

Proficiency

> "There are currently no additional requirements for individuals registered as dealing representatives of an investment dealer who are also members of the Investment Industry Regulatory Organization of Canada (IIROC)."

Comment: The strategies employed in liquid alts are as complex as their underlying hedge funds. Hedge funds require special proficiency requirements. Thus the choice is simple: either remove the proficiency requirements for hedge funds, or introduce the same proficiency requirement for liquid alts.

I can be reached at 416 504 9767 x 101 should you require further clarification.

Regards,

Jerome Hass
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VIA EMAIL

December 20, 2016

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 Consumer Services Commission of 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

Delivered to:

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Dear Sirs/Mesdames:

RE: CSA Request for Comments – Modernization for Investment Fund Product Regulation – Published for Comment on September 22, 2016 (the "Proposed Amendments")

Lysander Funds Limited is registered as an Investment Fund Manager in Ontario, Québec and Newfoundland & Labrador and as an Exempt Market Dealer in Ontario.

We are restricting our comments to the shorting, borrowing and leverage limits under the Proposed Amendments. We are the manager of two non-redeemable funds, also known as closed-end funds. We are particularly focused on the application of the Proposed Amendments to our closed-end funds, which have been in operation for several years.

1. **Shorting Limit of 50% of NAV**

We believe that a fund should have the ability to fully hedge a portfolio of long assets by shorting securities against them (subject to other restrictions e.g. leverage limits). This is a key component of portfolio risk management, and we believe that for closed-end funds at least, the shorting limit should be set to 100% of NAV. This strategy of fully hedging a portfolio is routinely used by IIROC firms when managing their own portfolio exposures and reducing their risk.

At a minimum, we believe that the shorting of "risk-free" assets like Government of Canada bonds, U.S. Treasuries and other government securities should be exempt from the limit of 50% of NAV. Our closed-end funds invest in corporate bonds, whose prices are quoted using spreads against government bonds. A key component of our strategy is to hedge interest rate risk by shorting government bonds against our long corporate bond positions. This has been an essential and very appropriate way to hedge against interest rate risk. The funds' prospectus explicitly discloses that we employ this strategy, and we have marketed the funds to investors on this basis. Under the Proposed Amendments we would be unable to effectively hedge all the interest rate risk, which would be detrimental to our unitholders and would be contrary to what was promised to unitholders upon initial purchase.

Alternatively, as the investment objectives and strategies of our existing funds were established to comply with the current regime, we submit that if the Proposed Amendments are adopted , that there be included a provision which would permit existing funds be grandfathered to continue to operate in their current manner under an exemption from the leverage, borrowing and shorting limits of the Proposed Amendments.

2. **Combined Shorting and Borrowing Limit of 50% of NAV**

In a scenario where a closed-end fund has fully hedged its interest rate risk by shorting "risk free assets" up to 100% of its NAV as described above, we believe that the fund should still be able to borrow some cash at up to 10% of NAV in addition. This would be to deal with a variety of situations including covering operating cash shortfalls, ongoing investment reasons, or funding redemptions.

We therefore submit that the combined limit for shorting and borrowing be 110% of NAV.

3. Leverage Limit

We believe that for closed-end funds the aggregate gross exposure limit for borrowings, short selling and derivatives should be extended from the contemplated 3 times NAV to 4 times NAV.

A leverage limit of 4 times NAV would allow a closed-end fund to:

- short up to 100% of NAV for credit/interest rate hedging purposes;
- pledge collateral against borrowings of securities from a prime broker, which could amount up to 200% of NAV;
- hedge currency exposure through forward contracts with a notional value up to 100% of NAV.

It is therefore possible to require a leverage limit of 4 times NAV so a fund can fully hedge credit and/or interest rate risk and currency exposure, while at the same time pledging the required collateral with a prime broker.

As outlined above, investors expect that we will fully hedge credit and/or interest rate risk based on the fund's prospectus and they will not be aware that we are no longer permitted to do so based on a subsequent rule change. We believe this change would be detrimental to the unitholders interest.

Thank you for considering our comments. Please contact me if you would like additional information or wish us to elaborate on our comments.

Yours very truly,

Raj Vijh
Lysander Funds Limited
rvijh@lysanderfunds.com

cc: Richard Usher Jones, President and Ultimate Designated Person, Lysander Funds Limited

December 20, 2016

CSA members,

I read with interest the proposed amendments to National Instrument 81-102 to permit the offering of Alternative Funds.

I should preface my comments by saying I am not lawyer. BLG does our legal work and they have not reviewed this note. I solely take responsibility for my comments and apologize in advance any comments which may be simplistic.

The McElvaine Investment Trust was formed in 1996 and since formation has been distributed under Offering Memorandum.

1. Performance history

   Without a doubt this is self-serving however I would suggestion track record ***prior to conversion to a prospectus alternative fund is important information for the public***. Unlike a current prospectus fund, your new framework will allow many alternative funds to continue with their existing investment approach. I believe having access to the fund's prior performance enhances investors' ability to make a judgement on the fund. Of course, a key consideration is that the alternative fund when converting to prospectus will not be substantially changing its investment approach.

2. Calculation of Net Asset Value

   While I appreciate frequency of NAV calculation is covered under NI 81-106, I nevertheless think it is an important consideration for Alternative Funds. The frequency of NAV valuations has a direct impact on a Fund's need for liquidity. This in turn impacts issues surrounding concentration and illiquid assets.

   NI 81-106 14.2 (3) requires a Fund to calculate its net asset value weekly if it does not use specified derivatives. I believe the current definition of "specified derivatives" would result in a number of Alternative Funds being valued daily. The result of this translates into increased costs to investors as well as an increase need for liquidity.

   My suggestion is to expand the definition of "specified derivatives" to exclude the use of derivatives for currency hedging. This in turn will allow a fund using only currency hedging derivatives to value once a week.

   It seems to me this type of use of derivative reduces risk in a portfolio and the use of such an instrument should not result in increased costs of investors of a daily valuation.

3. Concentration

Your concentration suggestion of 20 soft, 25% hard seems reasonable.

While not addressed, ***I do think it would be appropriate to allow alternative funds to acquire up to 20% of the votes of an issuer.*** This is not inconsistent with other changes and from a practical point of view, fund managers currently may own more than 10% of votes but do so via several funds.

Allowing an alternative fund is hold 20% of an issuer does not weaken the compliance framework. As a safeguard, the definition of illiquid investment could be expanded to include any securities of an issuer where the fund (or manager) control more than 10% of the votes.

4. Illiquid assets

My response is somewhat tempered by the frequency of valuations. In the case of a fund such as ours which values less frequently than daily, I feel your suggestion of a 10% cap on illiquid especially listed illiquid investments appears low.

I suggest there are in fact 3 classes of illiquid investments:

- Illiquid assets listed on an exchange:
  I realize the issue is simply whether a fund is able to sell identified securities within a reasonable time frame at the price quoted. A listed security, no matter how frequently it trades, is still by its nature much more liquid than an unlisted asset.

  I would suggest a soft cap of 20% and hard cap of 25% is reasonable for a fund holding <u>listed</u> illiquid assets.

- Illiquid assets not listed on an exchange
  I acknowledge especially in the age of structured products, an unlisted investment may take many forms. Nevertheless, by its nature an unlisted asset is less liquid. I would suggest current restrictions are reasonable for illiquid assets not listed on an exchange.

- Restricted securities
  The simple solution would be to use existing limits on this type of asset. A more complex solution would be to allow more lenient limits if remaining restriction period is say less than 30 days.

Given the different nature of each of these illiquid assets, I suggest the illiquid asset limitation be as follows:

Illiquid assets in aggregate (listed, unlisted and restricted) have a soft cap of 20% and hard cap of 25%. In addition, "illiquid assets not listed on an

exchange" as well as "restricted securities" in aggregate have a soft cap of 10% and hard cap of 15%.

I hope my comments have been of some use and I am of course available if any clarification is required.

Respectfully

Tim McElvaine

BLACKROCK®

December 21, 2016

Submitted via electronic filing: 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
Autorité des marchés financiers
Financial and Consumer 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:
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Me Anne-Marie Beaudoin
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Re: CSA Notice and Request for Comment - Modernization of Investment Fund Product Regulation – Alternative Funds ("Proposed Amendments")

Dear Sirs/Mesdames:

A. About BlackRock

BlackRock Asset Management Canada Limited ("**BlackRock Canada**" or "**we**") is an indirect, wholly-owned subsidiary of BlackRock, Inc. ("**BlackRock**") and is registered as a portfolio manager, investment fund manager and exempt market dealer in all the jurisdictions of Canada and as a commodity trading manager in Ontario.

BlackRock is one of the world's leading asset management firms. We manage assets on behalf of institutional and individual clients worldwide, across equity, fixed income, liquidity, real estate, alternatives, and multi-asset strategies. Our client base includes pension plans, endowments,

foundations, charities, official institutions, insurers, and other financial institutions, as well as individuals around the world.

B. General Observations

BlackRock commends the Canadian Securities Administrators ("**CSA**") on its ongoing work to modernize investment fund product regulation and to help facilitate more alternative and innovative strategies for retail investors. As a general principle, we support initiatives that encourage long-term savings by broadening the choice of investments offered to investors. Providing market participants with the enhanced ability to offer retail investors diverse investment strategies that seek to mitigate risk, capitalize on market inefficiencies or deliver more consistent returns in volatile markets can further the CSA's goal of investor protection while enhancing Canada's competitiveness in rapidly innovating global markets.

The Proposed Amendments mark a major shift in the Canadian market, and as such, we encourage the CSA to take a holistic, outcome-driven approach to implementing any regulation, while emphasizing its underlying policy goals. In particular, we recommend that the CSA be thoughtful and deliberate in its approach in distinguishing between "alternative" and "conventional" funds, with a particular focus on investment strategies that relate to leverage, liquidity and overall portfolio volatility. Regulations which introduce ambiguity surrounding which investment strategies are permitted to be used by conventional funds, and which are reserved solely for alternative funds could be exploited by some industry participants, ultimately misleading investors. Clear and specific guidance surrounding allowable and prohibited investment strategies that emphasizes substance over form and with an explicit relationship to policy objectives would benefit industry participants and investors alike.

Beyond this general caution, we have questions and concerns regarding certain of the Proposed Amendments as they relate to alternative funds, which are set out in greater detail below. For ease of reference, we have included the full text of each consultation question to which our comments correspond.

We are also supportive of the Proposed Amendments that would modernize and provide increased flexibility to conventional mutual fund strategies. To that end, we have taken this opportunity to identify certain other areas of National Instrument 81-102 – *Investment Funds* ("**NI 81-102**") which we believe also merit further consideration for modernization.

C. BlackRock's Responses

1. Proposed Amendments Relating to Alternative Funds

A. 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?

BlackRock supports the replacement of the term "commodity pool" with "alternative fund" and believes it is reflective of the funds that would be subject to the Proposed Amendments.

B. 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.

BlackRock supports the CSA's proposals to provide alternative funds with increased flexibility to use long/short strategies. We note, however, that setting the proposed limit on the aggregate market value of all securities that may be sold short by an alternative fund at 50% of net asset value ("**NAV**") could preclude certain common alternative strategies from being offered under the proposed framework, including market neutral strategies.

Market neutral strategies generally seek to generate returns based on perceived pricing asymmetry while limiting general market exposure, often by taking long positions in securities considered undervalued, while taking short positions in securities considered overvalued. As market neutral funds tend to employ long/short positions in up to 100% of a portfolio's NAV, the current framework, as proposed, may serve to either prohibit these strategies from being offered or inadvertently increase the risk by disallowing shorting beyond the 50% limit. Market neutral strategies aim to provide returns that are unrelated to those of the overall stock market, and can offer investors significant diversification potential. In addition, since market neutral strategies are designed to mitigate risk, a fully long-short market neutral portfolio could have significantly less risk than a portfolio with 50% of NAV in short positions. In this respect, we recommend that the CSA revisit the Proposed Amendments as they relate to such strategies, with an emphasis on risk mitigation rather than prescriptive limitations. In addition, we suggest that the 50% limitation on shorting apply on a net rather than gross basis.

A. 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.

BlackRock supports the proposed increase of the concentration limit for alternative funds to 20% of NAV at the time of purchase and suggests extending this same flexibility to conventional mutual funds. We note that NI 81-102 already contains an exemption from the 10% concentration limit for an index participation unit that is a security of a mutual fund[1], and recommend that this exemption be extended to non-index products as well, subject to enhanced disclosure regarding increased concentration risk (similar to what is currently required for index mutual funds). We believe this increased limitation will still provide the potential for meaningful diversification while allowing greater flexibility in investment strategies and increased options for investors.

B. Illiquid Assets

[1] Section 2.1(2)(d) of NI 81-102

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.

We agree with the underlying principle that a limitation on the amount of illiquid assets that can be held by a mutual fund is appropriate, and that setting reasonable controls on and monitoring the use of illiquid assets can reduce the risk to end investors. We believe, however, that the current definition of "illiquid assets" in NI 81-102 is unclear, and does not adequately further these principles.

Currently, "illiquid assets" are defined as "*portfolio assets that cannot be readily disposed of through market facilities on which public quotations in common use are widely available at an amount that at least approximates the amount at which the portfolio asset is value in calculating the net asset value per security of the mutual fund*". The underlined phrase is difficult to interpret when dealing with securities that commonly trade in over-the-counter ("**OTC**") markets such as fixed income securities, and creates ambiguity surrounding the liquidity of these securities for regulatory purposes, even when they are actively traded. Refining this definition to more appropriately capture OTC traded securities would be a welcome clarification in order to reflect current market practices and align with the CSA's policy goals.

C. 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.

BlackRock supports the flexibility in the Proposed Amendments for alternative funds to borrow up to 50% of their NAV in order to facilitate a wider array of investment strategies. We are concerned, however, that the Proposed Amendments restrict funds to borrowing only from entities that qualify as investment fund custodians under Section 6.2 of NI 81-102. As the CSA notes, this restricts borrowing to banks and trust companies in Canada and to their dealer affiliates. We note that many products currently offered in the alternative space utilize prime brokers to provide customized bundles of services, including execution, custody, lending and margin financing. While the CSA mentions in the summary of comments to the Proposed Amendments that dealers that act as prime brokers in Canada would qualify as eligible custodians under s. 6.2 of NI 81-102[2], we recommend that the CSA revise the borrowing rules to clearly permit the use of prime broker entities, including non-Canadian banks and their affiliated dealers in order to allow alternative funds to continue to make use of prime brokers. In order to mitigate potential counterparty risk, the CSA could consider requiring alternative funds to utilize a minimum of two prime brokers.

More generally, the ability to borrow from foreign lenders is important for many funds, as it has the potential to increase efficiency and reduce costs. As the current proposals would concentrate borrowing to a small number of Canadian entities, widening the ambit of potential lenders could also serve to limit counterparty risk. To address these concerns, we encourage the CSA to introduce provisions allowing for the recognition of foreign lenders, similar to the framework currently in existence for foreign custodians.

[2] Proposed Amendments, Page 8070.

D. Leverage

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.

It is important to note that leverage within portfolios can be used for many reasons, aside from strictly speculation. These uses include hedging (mitigating) risks to which the portfolio is subject, replicating the characteristics of physical securities, managing volatility, enabling better liquidity, and generating portfolio exposures to implement an investment view. While it is true that many derivatives may introduce notional leverage into a portfolio, the economic exposure and overall risk of the portfolio will vary depending on both the intended use of the derivative and the instrument utilized.

In this regard, while we are supportive of the CSA defining a comprehensive measure of leverage, we believe that any leverage limit imposed should incorporate a measure of economic exposure obtained through the use of leverage (and accounting for the fact that derivatives used for hedging do not create leverage). Notional exposure, while helpful for providing a base level indication of the overall use of derivatives by a fund, is not appropriate for use as a leverage limit. When used in isolation and without consistent adjustment for risk, notional exposure does not provide a meaningful indication of the risk associated with the use of leverage for the vast majority of portfolios, and could result in misleading conclusions made by investors about the risk exposure of a fund. A comprehensive measure of economic exposure obtained from the use of leverage ("economic leverage") that incorporates borrowings and derivatives and is consistent with global standards is the best approach to introducing a leverage limit in NI 81-102.

Rather than implementing a new standard, we encourage the CSA to instead consider the existing methods of calculating risk used in Europe under the Undertakings For the Collective Investment in Transferable Securities ("**UCITS**") and the European Alternative Investment Fund Managers Directive ("**AIFMD**") frameworks. While imperfect, we believe these are well established means of limiting or measuring leverage in funds. The AIFMD method includes both a calculation of gross notional exposure, as well as a measure of economic leverage that captures borrowings and structural leverage stemming from derivatives positions with exclusions for offsetting and hedge positions (the "**Commitment Approach**"). The UCITS framework permits fund managers to calculate risk exposure based on either an approach similar to the Commitment Approach, or Value at Risk ("**VaR**"), a commonly used measure of risk that estimates how much a set of investments might lose, given normal market conditions, in a set time period. Harmonizing the CSA's approach with global standards would lead to both international consistency and ease of use and implementation for Canadian market participants.

2. Other Suggested Amendments

We strongly support the Proposed Amendments to NI 81-102 that would provide additional flexibility for conventional mutual funds, namely expanding the scope of permitted investment in

physical commodities and reducing the limitations on fund of fund structures. While these Proposed Amendments are welcome and useful, there are certain other areas of NI 81-102 we believe also merit further attention in order to better achieve the CSA's goal of modernizing investment fund product regulation in Canada.

A. Specified Derivatives

As we understand it, the policy objectives underpinning the rules relating to the use of specified derivatives by conventional mutual funds in ss. 2.7, 2.8 and 2.9 of NI 81-102 are twofold: 1) limiting of the use of leverage; and 2) managing counterparty risk. As discussed above, we acknowledge that the use of derivatives can present risk, and agree with the implementation of reasonable limits on derivatives exposure within conventional mutual fund portfolios. In our view, however, streamlining and simplifying these rules could better achieve the CSA's intended outcomes.

Specifically, the current rules with respect to leverage and cash cover are overly complex in that they require fund managers to classify derivative instruments based on defined categories. This is an increasingly difficult exercise given the growth and evolution of derivatives. Derivatives, by their very nature, are a fluid and evolving category, and regulation should recognize this. Structuring rules around rigid categorizations or even colloquial names can also be ineffective, as it is possible to produce the same economic exposure using a variety of different instruments or combinations of instruments. Further complicating the analysis is the requirement to distinguish between "long" and "short" positions in certain assets. This distinction is not always straightforward, as many derivatives include elements of both long and short economic exposure. The application of the cash cover requirements and related definitions is also not entirely clear. Namely, the concept of "underlying market exposure" is difficult to interpret when dealing with contracts with a theoretical notional amount; e.g., interest rate futures.

Rather than focusing on specific labels and categorizations, we would encourage the CSA to instead clarify and reconsider these rules with a view to taking a more principles based approach to the regulation of derivatives use by investment funds. We suggest that the rules focus on the nature of the instrument used, and the overall economic exposure and risk of a portfolio. Taking such an approach will better align with the CSA's overall policy goals, and will provide greater consistency and simplicity for investors and industry participants alike.

With respect to counterparty risk, we would encourage the CSA to revisit the definitions of "designated rating" and "equivalent debt" in NI 81-102. In our view, the definition of designated rating is unduly restrictive in that it requires industry participants to monitor the ratings provided by all four named designated rating agencies on a continuous basis. The CSA itself notes that fewer firms have been able to attain a designated rating since the financial crisis, and has proposed relief from this requirement for alternative funds to provide them with access to a greater number of counterparties[3]. We believe that access to a larger variety of counterparties would also benefit conventional mutual funds in terms of pricing, managing counterparty risk through diversification and product choice, ultimately benefitting end investors.

We suggest that the CSA consider the recent Dodd-Frank reforms implemented in the United States[4], which require the replacement of mandatory credit-ratings in securities legislation with

[3] Proposed Amendments, page 8056

[4] Dodd-Frank Wall Street Reform And Consumer Protection Act of 2010, s. 939A

other more appropriate standards. As an example, the Securities and Exchange Commission recently removed the credit rating requirements in money market fund legislation, instead limiting money market funds to investing in a security only if the fund determines that the security presents minimal credit risks after analyzing certain prescribed factors[5].

Similarly, we feel that the definition of "equivalent debt" is rife for reform. Matching the term of an evidence of indebtedness to the term of a derivative instrument is often a difficult exercise, and is not an accurate determination of the length of the obligation. We suggest that this definition instead simply refer to credit rating of the counterparty or guarantor, as applicable.

Finally, we welcome further guidance surrounding the interpretation of the 10% counterparty exposure limitation in s. 2.7(3) of NI 81-102 and encourage the CSA to consider how, if at all, this exposure could be mitigated through collateralization rather than rigid limitations.

B. Securities Lending

As another modernization initiative, we suggest that the CSA revisit the rules relating to permitted collateral in securities lending transactions.[6] Amending the collateral schedule to allow for the delivery of equities would put NI 81-102 funds on par with other global products who accept equities as collateral, including UCITS funds in Europe, and would increase the competitiveness of Canadian funds in the global securities lending market. As a risk mitigation mechanism, agent lenders and fund managers would determine the appropriate level of collateralization for these securities, at all times meeting the 102% market value minimum threshold in NI 81-102.[7]

D. Conclusion

BlackRock appreciates the opportunity to provide input on this important regulatory initiative and would be pleased to make appropriate representatives available to discuss any of these comments with you. We would also be happy to participate in any roundtable discussions.

Sincerely,

"Margaret Gunawan"

Margaret Gunawan
Chief Compliance Officer and Secretary, BlackRock Asset Management Canada Limited

[5] Securities and Exchange Commission, 17 CFR Parts 270 and 274. https://www.sec.gov/rules/final/2015/ic-31828.pdf

[6] NI 81-102, s. 2.12(6)

[7] NI 81-102, s. 2.12(5)(b)

LAWRENCE PARK
ASSET MANAGEMENT

December 21, 2016

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 Consumer 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

comments@osc.gov.on.ca and consultation-en-cours@lautorite.qc.ca

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

Lawrence Park Asset Management Ltd. ("**LPAM**") is pleased to have the opportunity to provide comments on the Canadian Securities Administrators' ("**CSA**") Notice and Request for Comment – Modernization of Investment Fund Product Regulation – Alternative Funds (the "**Proposed Amendments**").

LPAM is supportive of the CSA's ongoing policy work to modernize investment fund product regulation that will include a new category of funds offering investors access to a variety of alternative strategies. While the attractive risk reward profile and diversification benefits available through alternatives are welcome and desirable, we also appreciate that these strategies will expose investors to new risks and that it is important that investor protection also be a core component of the new regulation.

Our Business

LPAM is registered under the Securities Act (Ontario) as a portfolio manager, investment fund manager and exempt market dealer. LPAM currently manages investment funds that offer alternative strategies issued to investors pursuant to certain exemptions from prospectus requirements contained in National Instrument 45-106 *Prospectus Exemptions*. LPAM also has a portfolio management sub-advisory agreement with a number of National Instrument 81-102 *Investment Funds* ("NI 81-102") mutual funds.

The primary objective of LPAM's alternative investment strategy is to generate positive absolute returns with an emphasis on capital preservation and low correlation to traditional equity and fixed income markets. Our core strategy involves purchasing investment grade corporate bonds on margin from our prime brokers and selling short government bonds to maintain a low duration profile relative to our benchmark index. We target a volatility profile at or below the Canadian TMX Bond Universe, with significantly lower sensitivity to interest rates than traditional fixed income funds. Under the current rules, we are prohibited from offering our core strategy under NI 81-102, because we utilize leverage and short sales of government bonds.

Summary of our Comments

We welcome the Proposed Amendments as an opportunity to allow more investors to gain access to the benefits of various alternative strategies, including relative value fixed income strategies. Such strategies have proven to be efficient diversification vehicles for investors that have utilized them in the exempt market. While it is important that the new framework provide consistency in its regulatory approach, we also believe it is important to ensure the new regulations are not too restrictive on low risk strategies that use different investment vehicles to hedge portfolio risks.

We are concerned that the Proposed Amendments will introduce funds that offer leveraged versions of traditional investment strategies but will make it difficult to introduce funds that offer true alternative strategies with effective hedges in place. Therefore, the Proposed Amendments may provide only limited diversification benefits leading to an increase of risk in the investment fund universe which we don't think is consistent with the CSA's objective.

The current prohibition in NI 81-102 on the use of leverage is only one reason why alternative strategies are currently restricted to the exempt market. The other reasons are due to restrictions that prevent the use of a number of hedging techniques. It is important that the implications of these restrictions be revisited in the Proposed Amendments. These hedging techniques are effective tools to offset the additional risk associated with leverage. In particular, the Proposed Amendments will make it very difficult to offer a relative value fixed income alternative fund. To facilitate the inclusion of our core strategy in an alternative fund, the Proposed Amendments will have to include the flexibility that allows an alternative fund to generate all the permitted leverage through short sales and permit alternative funds to concentrate the short sales in a small number of government issuers.

Below we highlight 5 specific areas where we believe the Proposed Amendments could be improved.

1. **Prime Broker Accounts**

The prime broker model is a critical component for the efficient operation of alternative strategies and we propose part 6 of NI 81-102 be updated to allow the use of a prime broker by alternative funds. We believe a prime broker should be permitted to act as a custodian for the alternative fund's portfolio assets. In addition, we propose that a prime broker should also be permitted to lend cash and securities to the fund and act as a derivative counterparty. The portfolio assets held by the prime broker will be used as margin for the outstanding borrowings, short sales and derivatives. The prime broker(s) will also need to be exempt from the 10% limit in sections 6.8(1) and (2) and section 6.8.1(1).

One of the consequences of this arrangement is that all portfolio assets including those being used as margin for borrowings, short sales and derivatives will be held with one counterparty, the prime broker(s). However, it is our opinion that the fund's portfolio assets are safer if held in a single (or limited number of multiple) prime broker account(s) than if some of the portfolio assets are held in a custody account and the remaining portfolio assets are held as margin across a large number of borrowing and derivative counterparties. In our analysis, a generic alternative fund levered 2.5 times through the use of short sales and derivatives, operating under the Proposed Amendment's 10% limit on assets deposited as margin at a lending or derivative counterparty, would require the use of 10 counterparties that would in aggregate hold two thirds of the fund's portfolio assets. We haven't included the details of our analysis but they are available to the CSA upon request. We believe this will lead to the use of smaller, higher risk dealers, or foreign counterparties who are not regulated by IIROC. We believe this is not the intention of the Proposed Amendments.

If an alternative fund wants to borrow cash or securities or trade derivatives with counterparties other than their prime broker(s), any portfolio assets deposited as margin with those counterparties should be subject to the 10% limit.

We feel the primary focus of the CSA and the Proposed Amendments should be on the alternative fund's selection of its' prime broker. We propose that: (a) the CSA focus on regulating the entities that can qualify to act as a prime broker for alternative funds, for example, the prime broker must be an IIROC member that meets the criteria in sections 6.2.3 (a) and (b) of NI 81-102; (b) an alternative fund should be permitted to use a non-Canadian prime broker subject to that entity meeting the criteria in section 6.3 of NI 81-102; and (c) for larger funds, the prime broker counterparty risk could be further reduced by requiring the use of two or more prime brokers when the fund reaches a defined AUM threshold.

We also recommend the CSA consult with representatives from the Canadian prime broker industry to discuss the mechanics and structure of a prime broker account in more detail to ensure all the CSA's concerns are addressed in the prime broker account agreement that will govern the relationship between the alternative fund and the prime broker and to confirm that the Proposed Amendments will permit the inclusion of all the terms in the agreement.

2. Leverage Limit

We welcome the proposal to allow alternative funds to use leverage. There are a number of low risk alternative strategies that rely on the use of leverage to achieve attractive risk adjusted returns. However, we don't believe all alternative funds should be subject to the same leverage limit. Different alternative strategies have different risk profiles which should lead to different leverage limits. As an example, it is our opinion that the risk profile of low volatility relative value fixed income strategies can support a leverage limit of up to 5 times.

There are alternate approaches that can be used to calculate the leverage limit that the CSA should consider. The first would link the leverage limit to the risk classifications outlined in the Investment Funds Institute of Canada's ("IFIC") publication titled "Voluntary Guidelines for Fund Managers Regarding Fund Volatility Risk Classification" dated August 2014. The second would link the leverage limit to the IIROC margin guidelines that the prime brokers use to calculate their margin requirements.

We haven't included the details of our analysis on why these approaches are a more effective way of matching leverage limits to the underlying risk of the fund but we welcome the opportunity to provide those details if the CSA wants to explore them further.

3. Leverage Calculation

As noted in the Proposed Amendments there are three sources of leverage available to an alternative fund, borrowings, short sales and derivatives. It is our view that the regulations should set an overall leverage limit but not limit the amount of leverage that can be created by each of the three sources. An alternative fund that does not trade derivatives should be permitted to generate the permitted leverage using a combination of short sales and borrowings. Using the Proposed Amendments, an alternative fund that does not trade derivatives can achieve a maximum leverage of 1.5 times. And, relative value alternative funds that rely on short sales to hedge specific risks should be permitted to generate the leverage through short sales only. By restricting the use of borrowings and short sales to generate leverage the Proposed Amendments will promote increased use of derivatives to generate leverage. All sources of leverage have different risks but we feel none of the sources are riskier than the others if they are managed properly.

For many alternative strategies, short sales and derivatives are primarily used as hedges. These hedges will reduce the overall risk in the portfolio and should not restrict the fund's ability to use leverage. As such, we recommend short sales and derivatives that are designated as a hedge be excluded from the leverage calculation. The concept of exempting derivatives that are classified as a hedge from certain regulation already exists in NI 81-102.

The calculation of borrowings should be net of any cash and cash equivalents held in the same account. This may occur if an alternative fund purchases foreign currency securities and borrows that foreign currency to hedge the exchange rate risk despite the fact they are holding Canadian dollar cash.

4. Short Sale Issuer Concentration Limit

The short sale of government bonds is a widely used interest rate hedge methodology for relative value fixed income strategies. They are more efficient, more cost effective and lower risk than hedging the interest rate risk with derivatives. Therefore, we feel that section 2.6.1 of the Proposed Amendments should be amended to exclude government securities from the short sale single issuer concentration limit. This would be consistent with the exemption of government securities from the long issuer concentration limit in section 2.1 of NI 81-102.

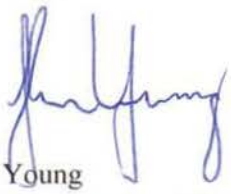
5. Subscriptions and Redemptions

While we agree that alternative funds should provide a reasonable degree of liquidity we believe the daily calculation of a net asset value and the corresponding processing of subscriptions and redemptions on a daily basis is too onerous and won't necessarily be demanded by prospective investors. We believe the operational demands on the manager and the fund's administrator and the incremental cost to the fund of providing daily liquidity isn't justified. We recommend that NI 81-106 be updated to permit alternative funds to calculate net asset value on at least a monthly basis. This will allow the alternative funds to process subscriptions and redemptions on the same frequency. We further recommend that the alternative fund's subscription and redemption terms be clearly disclosed in its prospectus.

Conclusion

We appreciate the opportunity to comment on the Proposed Amendments. We would welcome the opportunity to meet with the CSA to further discuss our recommendations and to discuss our experiences in the exempt market. We feel this is a great opportunity to update the current rules but it is important that the changes achieve the objectives and goals of the CSA.

Sincerely,



John Young
Chief Compliance Officer

Andrew Torres
Chief Investment Officer

December 21, 2016

British Columbia Securities Commission
Alberta Securities Commission
Financial and Consumers Affairs Authority of Saskatchewan
The Manitoba Securities Commission
Ontario Securities Commission
Autorité des marchés financiers
Financial and Consumer Services Commission (New Brunswick)
Office of the Superintendent of Securities, Prince Edward Island
Nova Scotia Securities Commission
Office of the Superintendent of Securities, Newfoundland and Labrador
Office of the Superintendent of Securities, Northwest Territories
Office of the Yukon Superintendent of Securities
Office of the Superintendent of Securities, Nunavut

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Dear Sirs/Mesdames:

Re: CSA Notice and Request for Comment
Modernization of Investment Fund Product Regulation -- Alternative Funds[1]

We are writing to provide our comments on the Canadian Securities Administrators' (CSA) proposed Alternative Fund amendments to National Instrument 81-102 – *Investment Funds* ("NI 81-102") and National Instrument 81-101 -- *Mutual Fund Prospectus Disclosure* ("NI 81-101"), and certain consequential amendments to other

[1] (2016), 39 OSCB 8051 (September 22, 2016)

instruments (collectively with NI 81-102 and NI 81-101, the "Instruments"), including the proposed repeal of National Instrument 81-104 – *Commodity Pools* (collectively "the Proposed Amendments").

Investors Group Inc. (Investors Group) is a diversified financial services company and one of Canada's largest managers and distributors of mutual funds, with assets under management of over $80 billion at November 30, 2016. Investors Group distributes its products through more than 5,000 Consultants engaged with its subsidiaries, Investors Group Financial Services Inc and Investors Group Securities Inc., which are members of the Mutual Fund Dealers Association (MFDA) and the Investment Industry Regulatory Organization of Canada (IIROC), respectively.

General Comments

We thank you for the opportunity to comment on the Proposed Amendments. We support the CSA's approach to consolidate all investment requirements for retail funds into NI 81-102, and to expand the framework of NI 81-102 to recognize the unique investment strategies employed by Alternative Funds.[2]

Further, we concur with many of the key changes made to the proposed regulatory framework for alternative funds (the "2013 Alternative Funds Proposal")[3], and appreciate the CSA's responsiveness to industry comments. Specifically:

- migration of the proficiency requirements to become compliance requirements enforced by the SROs;
- removal of the naming convention requirement and the definition of Alternative Fund under the Instruments;
- expanded ability of conventional funds to invest in Alternative Funds that are subject to the investment protections found in NI 81-102, although we encourage the CSA to consider providing more flexibility for conventional funds to invest in Alternative Funds (as discussed below);
- expanded ability of conventional funds to invest directly or indirectly in physical commodities;
- recognition through the 'inter-related investment restrictions' that non-redeemable investment funds do not have the same illiquidity concerns as conventional funds and for most purposes should be afforded similar investment abilities as Alternative Funds. This includes expanding the ability of non-redeemable funds to utilize short-selling strategies similar to Alternative Funds, and we also encourage the CSA to consider providing more flexibility for conventional funds to utilize short-selling strategies (as discussed below);

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[2] The CSA could further streamline NI 81-102 by deeming non-redeemable funds to be Alternative Funds (such that the Instrument will categorize funds as being either conventional or alternative), given that many of the expanded investment capabilities that will be available to Alternative Funds will equally apply to non-redeemable funds through the proposed inter-related investment restrictions.

[3] Originally issued for comment as part of Phase 2 of the CSA's Modernization Project on March 27, 2013.

- exemption for all funds from ss. 2.7(1) and 2.7(4) of NI 81-102 for exposure to 'cleared specified derivatives' and
- application of the prospectus disclosure regime (simplified prospectus, Annual Information Form and proposed 'ETF Facts' documents) to Alternative Funds.

Overall we believe this updated investment funds framework will provide appropriate access to Alternative Funds by retail investors which we believe is important to achieving good investment outcomes for retail clients in today's markets. However, we do have some additional recommendations for you to consider before finalizing the Proposed Amendments.

It is with the CSA's objectives set out in the 2013 Alternative Funds Proposal in mind that we provide our comments that follow.

Fund-of-Funds Structures

As mentioned above, we encourage the CSA to consider providing more flexibility for conventional funds to invest in Alternative Funds (as discussed below) - such as when the Alternative Fund is listed, or if an investment in an Alternative Fund is employed as part of a hedging strategy by the conventional fund to reduce the overall volatility of its portfolio. We suggest allowing any conventional fund to invest up to 10 percent of its net assets in any single Alternative Fund, provided that its aggregate investment in Alternative Funds does not exceed 20%. This additional flexibility will be especially useful for conventional funds that pursue a general 'asset allocation' strategy as it would allow them the opportunity to better diversify their assets among a greater range of asset classes. If necessary, the CSA could require that any conventional fund wishing to invest more than 10% of its net assets in an Alternative Fund must then specifically include this strategy as part of its fundamental investment objective (or investment strategies, as applicable), in its offering document(s).

Short-Selling (Alternative Funds)

We concur with allowing Alternative Funds to invest up to 50 percent of their net assets in short-selling transactions, as well as with the more flexible investment requirements associated with the use by Alternative Funds of short-selling strategies. However, we strongly encourage the CSA to consider providing a carve-out to permit Alternative Funds to invest up to 100 percent of their net assets in short-selling transactions that are utilized as part of a market-neutral risk management strategy.

We make this recommendation because it is becoming increasingly more difficult to achieve optimal risk-adjusted returns through the use of diversification alone, due to the fact that market sectors and asset classes are becoming increasingly more positively correlated, especially in circumstances when investors seek 'safe-haven' investments during times of elevated market volatility. However, minimal market equity exposure may be attained through 'market-neutral' strategies that can be established by short-selling up to 100% of a fund's net assets, with the proceeds invested in cash or money

market instruments.[4] These short-sale positions act as a hedge against the fund's long positions in the same asset classes or sectors (as applicable) thereby allowing the fund to exploit opportunities on specific stocks while maintaining a net 0% long exposure to those market sectors, asset classes, regions/countries or market capitalization, etc. This helps negate the influence of broad market movements on fund returns. Accordingly, market-neutral strategies can act as a stabilizer and diversifier for a portfolio. Using this strategy together with periodic portfolio rebalancing, the value of the long positions in a fund will be approximately equal to the fund's borrowing obligations in connection with its short-sale positions such that the fund has assumed no additional leverage[5] while allowing investors to be minimally affected by sector-wide events.

Illiquid Assets/Short-Selling (conventional funds)

We understand the CSA's concerns as regards the ability of conventional funds to invest in illiquid assets, but encourage the CSA to consider providing more flexibility to allow those funds to increase their investments in illiquid securities up to 15% of their net assets (up from the current 10%), with a 'hard cap' at 20% (rather than 15%). We believe that this will allow room for conventional funds to take advantage of more long-term investments in real infrastructure projects, enhance their income from infrastructure loans, and facilitate their ability to participate in more private equity opportunities, similar to those available to pension plans.

We also encourage the CSA to consider providing more flexibility for conventional funds to utilize short-selling strategies as it has been our experience that fund managers are reluctant to take advantage of the current limits in NI 81-102 because the requirements to hold 150% cash cover, and to invest the proceeds in instruments that would qualify as cash cover, present too much of a performance drag to make use of a short-selling strategy worthwhile – other than for hedging purposes. Therefore, we ask the CSA to ease these requirements (such as by reducing the cash cover requirement to 100%) so more conventional funds will utilize short-selling strategies, either generally or perhaps in certain circumstances such as when a conventional fund wishes to manage its overall volatility using a market-neutral strategy (as discussed above for Alternative Funds) to negate market or sector-wide volatility.

Leverage

We support the expanded ability of Alternative Funds and non-redeemable funds to achieve leverage through cash borrowing, short-selling and specified derivative transactions as proposed, but urge the CSA to adjust the calculation of the aggregate

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[4] Market-neutral strategies are similar to long/short strategies as both seek to manage market-wide volatility, but differ in that long/short strategies typically share in equity market swings because portfolio managers can, and often do, have unequal sums invested in their long and short positions. By shorting stocks they consider unattractive and taking long positions in stocks they consider attractive, managers seek to enhance the spread in performance between the strongest stocks and weakest stocks in a sector or asset class.

[5] We suggest that funds that adopt a market-neutral strategy should be subject to a leverage limit of no more than 1.5 times the value of their net assets committed to this strategy with respect to that portion of their portfolio.

gross exposure amount for purposes of determining the 3 times NAV limit, by the following:

i. excluding the notional amount of short-sales entered into for hedging purposes, such as short-selling transactions entered into as part of a 'net long/short position' where the manager has entered into offsetting positions, as this would facilitate their ability to hedge risk exposures, and would be consistent with the ability of conventional funds to utilize hedging strategies. We do not share the CSA's concern that the gross aggregate value of hedged positions should be included, given that the existing NI 81-102 investment restrictions regarding short-selling and specified derivatives already assume that fund managers have the ability to determine when a fund has or has not entered into a transaction for hedging purposes; and
ii. adjusting the calculation to account for positions, such as an out of the money long call option held by the fund, where the fund's immediate delivery obligation is tied to premiums paid as opposed to delivery of the entire notional amount.

These carve-outs will exclude transactions that do not contribute to overall leverage and, in fact, may reduce a fund's overall risk exposure. Therefore, Alternative Funds should not be discouraged from pursing these strategies by having them included in their leverage limit.

In addition, we suggest that the CSA consider increasing the maximum leverage limit for Alternative Funds and non-redeemable funds to something greater than 3 times their NAV. In this regard it has been our experience that some existing Alternative Funds that seek to achieve risk/return characteristics of balanced funds offering a long-term equity/debt target range of 60/40 under normal market conditions have adopted investment strategies that make use of leverage limits of 4 times NAV (with the ability in some circumstances to increase their leverage up to 6 times NAV) without significantly increasing their long-term volatility[6].

Proficiency Requirements

As mentioned above, we agree with the removal of the proficiency requirements from the Instrument and concur that it is more appropriate that these be prescribed and supervised by the MFDA (or other applicable SROs) consistent with all other proficiency requirements for registrants.

In this regard, we urge the CSA to encourage the adoption of a principles-based approach that would allow dealers sufficient flexibility to accommodate a wide-range of products, provided that advisors comply with the Know-Your-Product requirements and that dealers maintain adequate processes to review and assess the Alternative Funds that their advisors may recommend to ensure that they are suitable for their retail clients. This is consistent with the approach adopted by the MFDA under Rule 1.2.3

[6] For example, we currently offer the Investors Risk Parity Pool to qualified clients on a prospectus-exempt basis. This Pool seeks to achieve a risk adjusted long-term return similar to a 60% equity/40% debt balanced fund and is permitted to adopt investment strategies that make use of leverage limits of up to 4 times NAV.

(*Education, Training and Experience*) where an Approved Person must not perform an activity that requires registration under securities legislation unless the Approved Person has the education, training and experience that a reasonable person would consider necessary to perform the activity competently, including understanding the structure, features and risks of each security that the Approved Person recommends[7]. This also reflects the current principles-based approach under National Instrument 31-103 *Registration Requirements, Exemptions and Ongoing Registrant Obligations* ("NI 31-103").

Risk Disclosure

Finally, we continue to support the use of standard deviation for purposes of risk disclosure in the Mutual Fund Risk Classification Methodology[8] (the "Methodology"), but recommend that fund managers be permitted to increase or decrease the risk classification of any Fund based on their assessment of qualitative factors.

The need for fund managers to be allowed to override the purely quantitative standard deviation risk metric so that they have discretion to both raise or lower the risk rating, however, is particularly important for Alternative Funds that use leverage. For Alternative Funds with less than 10 years of performance history, beyond determining appropriate reference indices, it is important that the fund manager determine the potential effect of the use of leverage both when the market behaves as the fund manager anticipates and the leverage increases or stabilizes return, and, in the event of unexpected market events where the effect of leverage may be to amplify negative returns.

For Alternative Funds with 10 years of performance history, the standard deviation of actual fund performance may not adequately capture the potential volatility of a leveraged investment. Fund managers should be permitted to consider whether the calculated standard deviation of actual returns adequately reflects the potential risk and, if it does not, to assign a risk category based on a more representative measure that models the effect of the use of leverage on potential volatility. In this case, where it would be unreasonable for a Fund Manager to reduce the risk ranking, it may be appropriate for the Fund Manager to continue to assign a higher risk ranking than the actual returns over a particular 10 year period may suggest.

This additional discretion will recognize the unique characteristics of the investment strategies that Alternative Funds may pursue as these strategies could be expected to

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[7] Proposed new MFDA Policy No. 8 *Proficiency Standard for Approved Persons Selling Exchange Traded Funds ("ETFs")* ("Policy No. 8") would establish minimum standards in respect of proficiency for Approved Persons trading in ETFs. Dealers could provide their own training, or seek courses offered by third-party service providers, provided that these courses meet the criteria required by the Standards outlined under Policy No. 8. These standards are intended to satisfy requirements under MFDA Rule 1.2.3.

[8] *CSA Mutual Fund Risk Classification Methodology for Use in Fund Fact and ETF Facts (2016), 39 OSCB 9915 (December 8, 2016)*

significantly increase or decrease their volatility relative to the reference index (or blend of indices) that managers may employ for this purpose.

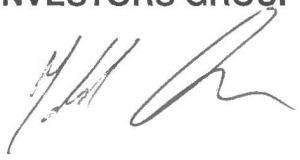
Adoption of a single risk classification methodology for use by all investment funds subject to NI 81-102 is desirable to ensure that to the greatest extent possible the risk disclosure among funds available to retail purchasers will be comparable. Considering the uniqueness of the strategies that various Alternative Funds may pursue, it is appropriate to contemplate some variation on the requirements for risk ranking in order to achieve the objective of providing meaningful comparisons for investors.

Therefore, in addition to the option of providing managers the discretion to raise or lower the risk rating of an Alternative Fund based on qualitative considerations when using the Methodology, we also recommend that fund managers be allowed to use (and base their Alternative Fund's risk disclosure on) such other risk classification methodologies that they may deem to be more appropriate (in addition to the Proposed Methodology), provided that an explanation of the additional methodology, including any material differences with the Methodology, is disclosed in the offering documents.

Thank you for the opportunity to provide comments on the Proposed Amendments. Please feel free to contact the undersigned, Scott Elson, Vice-President and Legal Counsel, Investors Group Financial Services Inc. (scott.elson@investorsgroup.com) or Douglas Jones, Assistant Vice-President and Counsel, Mutual Funds (doug.jones@investorsgroup.com) if you wish to discuss our submission or if you require additional information.

Yours truly,

INVESTORS GROUP INC.



Todd Asman
Executive Vice-President, Products and Financial Planning

RBC Capital Markets®

RBC Dominion Securities Inc.
PO Box 50
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December 21, 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
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

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 and Mesdames:

RE: CSA Notice and Request for Comments Modernization of Investment Fund Product Regulation –Alternative Funds

This letter is being submitted on behalf of RBC Capital Markets in response to the CSA Notice and Request for Comment published on September 22, 2016 concerning the Modernization of Investment Fund Product Regulation – Alternative Funds. RBC Capital Markets is supportive of the proposed changes regarding phase 2 of the modernization of investment fund product regulation. We are including comments on those provisions that we believe require further clarification or changes in order to better align with industry practice.

Entities Qualified to Act as Custodian

While we understand it is the OSC's view that Prime Brokers fall within the scope of section 6.2 of NI 81-102, we note that Prime Brokers do not meet all the requirements set out in Part 6. In particular, Prime Brokers may not have the intra-company infrastructure in place for an affiliated bank or trust company to assume responsibility for all of the custodial obligations of the broker dealer in order to meet the definition of a "custodian" under section 6.2 (3). In addition, Prime Brokers are not set up to meet the review and compliance reporting requirements set out

under section 6.7 of Part 6. Consequently, we would suggest that Prime Brokers be exempt from meeting the requirements set out in these sections.

Currently, alternative funds may use a Prime Broker to hold their assets and to provide borrowing and short selling facilities. These funds do not need to use custodians to conduct this business. If this is changed to require alternative funds and non-redeemable funds to use a custodian in addition to a Prime Broker, this will result in additional costs and will require the alternative fund and/or non-redeemable fund to develop and establish additional operational infrastructure. This may deter some alternative funds and non-redeemable funds from issuing securities pursuant to NI81-102. The incremental cost to add a custodian will be especially prohibitive for smaller and early stage funds, and is likely to impact fund performance and impede the growth of these entities.

Question 8 – Borrowing

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 and non-redeemable funds should be permitted to borrow from entities that qualify as borrowing agents in addition to custodians. Currently, alternative funds are able to borrow cash and both alternative funds and non-redeemable funds are able to short sell securities through a single margin facility established with their Prime Broker. This provides alternative funds and non-redeemable funds with an operationally and cost efficient method of borrowing cash and / or short selling securities as both may be done utilizing the same portfolio margin facility. If alternative funds and non-redeemable funds are restricted to borrowing from custodians only, this will limit these funds' access to borrowing facilities and may increase their borrowing costs; i.e. charges for standby credit facilities, higher borrowing rates, etc. Under the proposed amendments to section 6.8, alternative funds may be required to have multiple counterparties with at least one for each type of borrowing (cash, securities), which may increase operational risk and deter some alternative funds and non-redeemable funds from issuing securities pursuant to NI81-102. As noted above, the current practice of alternative funds and non-redeemable funds is to deposit fund assets as margin/security with a Prime Broker to cover their borrowing and / or short selling securities activity. If "borrowing" were included in 6.8.1 of NI81-102, rather than 6.8, alternative funds and non-redeemable funds will be able to continue this practice and the above risks will be mitigated.

Custodial Provisions

Alternative or non-redeemable funds should be allowed to deposit sufficient collateral with the borrowing agent as security against the borrow amount up to a new maximum of 50% of NAV for borrowing and / or short selling of a security.

The custodial provisions in sections 6.8 (2)(c) and 6.8.1 (1) relating to the maximum amount of portfolio assets deposited with a borrowing agent have not been amended to include the new borrowing and / or short selling limit for alternative and non-redeemable funds. The current portfolio asset deposit limit of 10% would be insufficient to satisfy a margin requirement with the borrowing agent when the allowable borrowing is 50%. Further, section 6.8.1(1) should be clarified to say that the proceeds from a short sale (or equivalent value) may be deposited with the Prime Broker/borrowing agent as margin/security [against the alternative fund's or non-redeemable fund's total net exposure to the Prime Broker/borrowing agent and] for the short sale of a security. That is, at the time the short sale proceeds are deposited into the alternative fund's or non-redeemable fund's account, the value of the short sale proceeds is netted with the value of the short sale security and this amount is excluded from the value of the alternative fund's or non-redeemable fund's assets on deposit with the Prime Broker/borrowing agent, subject to

the deposit limit. By way of background, the margin requirement on an equity security sold short position would be 150% of the market value which is calculated as 100% of the market value (i.e. the proceeds from the sale) plus 50% margin required.

Consequently, we propose that alternative and non-redeemable investment funds be allowed to deposit sufficient collateral with the Prime Broker/borrowing agent as security against the borrowing and / or short selling based on current regulatory margin rates for IIROC broker dealers and that short sale proceeds be included as eligible margin for this purpose.

We appreciate the opportunity to provide comments 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.

"Andrew Thornhill"

Andrew Thornhill
Managing Director, Equity Finance and Prime Brokerage

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December 21, 2016

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

Dear Sirs/Mesdames:

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

RP Investment Advisors ("RPIA") is a specialized, credit focused, alternative fixed income investment management firm that is registered as an Investment Fund Manager, Portfolio Manager and Exempt Market Dealer in multiple Canadian jurisdictions. RPIA is located in Toronto, Ontario and our principle regulator is the Ontario Securities Commission. We actively participate in the global fixed income market and currently manage over C$3.0 billion in assets, primarily on behalf of Canadian investors.

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RPIA is strong supporter of the CSA's endeavor to modernize the Canadian investment fund landscape, and particularly with regards to the role of alternative funds. Institutional and other sophisticated investors have, for some time now, been utilizing alternative investment strategies within their overall portfolios to help provide diversification, and to gain exposure to certain risk and return profiles that generically are not achievable through more traditional investments. We congratulate the CSA's efforts to ensure that the opportunities presented by alternative investments is made available to a broader range of Canadian investors. We truly believe in the value alternative strategies can provide as part of well diversified investor portfolios.

Notwithstanding our overwhelming support for the direction of the Proposed Amendments, we are of the view that certain aspects of the proposals should be reviewed and possibly reconsidered. We believe that these would positively contribute to the goal of providing Canadian investors with access to innovative alternative strategies, that if implemented appropriately, would complement their existing investment portfolios, and assist them in reaching their own investment objectives. Both from a performance and risk management perspective. We appreciate the opportunity to provide our thoughts and comments on this important regulatory initiative and will be pleased to provide additional information or participate in industry discussions as deemed appropriate by the CSA.

The purpose of this letter is to provide the CSA with comments regarding certain aspects of the Proposed Amendments. RPIA is a member of the Canadian section of the Alternative Investment Management Association ("AIMA Canada") and we would like to convey that we are generally in support of the views and comments of AIMA Canada, as they relate to the Proposed Amendments. As such, RPIA's comments may, where appropriate, directly or indirectly reference those expressed by AIMA Canada in their own comment letter. We note that where appropriate, we may also provide additional thoughts and comments of our own, that may not necessarily be reflected by those of AIMA Canada.

For the purpose of this letter, RPIA will directly address select questions posed by the CSA, followed by relevant supplementary comments.

Part 1 - CSA Questions

Question 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.

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Response

In the absence of specific redemption frequency requirements in the Proposed Amendments, RPIA would like to echo the views expressed by AIMA Canada, as detailed in their comment letter. We request that the CSA therefore consider the operational complexities and additional costs that could exist under a regime where the required frequency of NAV calculation, required purchase/redemption NAV (i.e. next NAV, or first or second business day following the purchase/redemption request) does not align with the purchase/redemption frequency set by the fund. As noted by AIMA Canada, an alternative fund that offers monthly purchases/redemptions, may need to execute these at up to 30 different NAVs on a single transactional day. This could result in severe operational difficulties, especially for smaller firms.

Question 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.

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, and it is RPIA's belief that this requirement would restrict borrowing for many alternative funds. We align our views with that of AIMA Canada and would like to highlight the following comments.

RPIA acknowledges that the Proposed Amendments are intended to permit an alternative fund to borrow from entities acting as prime brokers in Canada. However, we would like to highlight a specific concern with the requirement that all such lenders must qualify as a custodian under Section 6.2 of NI 81-102. As per the requirement, the equity of most bank affiliated dealers that provide prime brokerage services exceed the minimum $10,000,000. However, they generally do not prepare separate audited financial statements that are made public, as required by subsection 3(a). For the purpose of permitting an alternative fund to borrow from prime brokers in Canada, we agree with the comments of AIMA Canada, in that the CSA consider removing the requirement under Section 6.2(3)(a) that requires that a dealer's financial statements be made public. We would like to note that this would be in line with the definition of "Canadian Custodian" in the recently proposes amendments to NI 31-103.

The ability to borrow funds is crucial to many alternative fund strategies, and based on the circumstance, the efficiency and terms of loans could potentially be improved by borrowing from foreign lenders. For example, borrowing U.S. dollars from a U.S. domiciled lender in order to finance the purchase of U.S. dollar denominated securities. RPIA believes that it would be in the interest of alternative funds and investors alike

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to permit borrowing from certain foreign entities. We note that NI 81-102 currently permits qualified foreign entities to act as sub-custodians for investment fund assets held outside of Canada. To facilitate a practice whereby an alternative fund can obtain efficient and effective sources of funding, we propose that the CSA expand the scope of the current rule proposal to permit borrowing from foreign entities that are permitted to act as sub-custodians under Section 6.3 of NI 81-102.

Lastly, RPIA also agrees with the comments provided by AIMA Canada that the proposed borrowing limit of 50% of NAV should be calculated net of cash and cash equivalents that are held in the same account with the lender.

Question 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?

Response

RPIA strongly believes that specified derivatives that are used for hedging purposes should be excluded from the proposed leverage calculation. We agree that the current NI 81-102 definition of "hedging" adequately described transactions that are considered to be for hedging purposes, and are not proposing that the definition be amended.

Implementing hedging strategies forms part of the foundation of many alternative investment strategies and do not, in our view, contribute to the leverage or magnify the risk of a portfolio. In this sense, hedging is viewed and used as a risk-mitigating tool, and including the notional value of derivatives used for this purpose in the leverage calculation, will not provide investors with an accurate and transparent understanding of the risks that might be associated with an alternative fund.

We acknowledge previous CSA comments that note 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. We do however, want to respectfully emphasize the crucial role that hedging could play in mitigating certain risks within an alternative fund.

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As an alternative fixed-income manager focused on global credit securities, we are of the view that hedging against interest rate risk and foreign currency exposure is a valuable and necessary tool. A tool that can be effectively implemented to reduce risk within a credit focused portfolio, protect investor capital and ultimately allow a fund to pursue its stated investment objectives and deliver value to investors. Fixed-income securities are inherently exposed to interest rate risk. Using derivatives for hedging purposes allows managers like us to effectively minimize volatility associated with interest rate fluctuations, while focusing on building, what we feel, are optimal credit-focused portfolios for our investors. In our opinion, this results in a truly alternative asset class that compliments investment portfolios and we strongly feel that this supports the consensus views on the value of alternative funds as part of well diversified investor portfolios.

As noted, the importance of hedging is strongly echoed as it pertains to foreign currency investments. Many alternative funds hold securities denominated in foreign currencies, but maintain an objective to deliver optimal risk-adjusted returns to investors in the fund's local currency. Currency fluctuations can have a severely detrimental impact on investor returns, especially those invested in fixed-income securities, and many alternative managers disclose that they will employ currency hedging to help offset this risk. This could be an important consideration for certain investors and could impact their investment decision to invest in a particular fund, based on their own investment objectives.

In addition to the use of specified derivatives for hedging purposes, RPIA would like to highlight, the crucial importance of using short selling strategies for hedging. Interest rate risk, as discussed above, is a fundamental risk faced by fixed-income funds and alternative managers who provide investors with credit focused alternatives, and who commonly utilize short selling as an effective and efficient approach to hedging against interest rate risk. A primary example of this is a strategy whereby a manager invests in an investment grade corporate fixed-income security while simultaneously entering into a short sale of a corresponding and highly liquid government security, such as Canadian or U.S. government issues. A negative change in market value of the long position due to rising interest rates, for example, would be offset by a positive change in market value of the short position. This strategy makes it possible for a credit focused manager to effectively hedge against interest rate risk across a fixed-income portfolio and often without the need to make large scale use of the derivatives market. We note that the government securities sold short under such a strategy represent, what is widely considered to be some of the most liquid and least volatile investments available. Of note is that the use of this type of short selling strategy for hedging purposes supports our comments later in this letter pertaining to the issuer concentration restrictions related to short sales.

By aggregating the notional value of all short sales and derivative instruments for the purpose the leverage calculation, we feel that it not only provides the investor with an inaccurate view of the fund's use of leverage, and therefore the perceived risk, but restricts the fund from utilizing other true forms of leverage, such as borrowing and short selling for non-hedging purposes. This would curb the fund's ability to pursue optimal risk-adjusted returns for its investors.

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Based on our understanding of the Proposed Amendments, we would like to highlight that an alternative fund that intends to leverage its portfolio by borrowing up to a maximum permitted 50% of NAV, would not be able to employ short selling strategies or derivative instruments to effectively hedge its overall economic exposure against interest rate risk and foreign currency risk. If, for example, the fund fully invests the borrowed funds, along with the rest of its assets, in U.S. dollar denominated investment grade fixed-income securities, the nominal value of its economic exposure to interest rate risk and currency risk that would need to be hedged is magnified as a result of the leverage created by the borrowing. Aggregating the notional value of the required hedging instruments with the borrowing, will exceed the proposed permitted limit of 300% of NAV. In this scenario, a fund manager may need to prioritize the relative importance of interest rate risk vs. foreign currency risk and apply selective hedging. This approach could possibly be at odds with the fundamental investment objectives of a fund that states that it pursues a credit focused strategy that aims to fully hedge both interest rate risk and foreign currency risk. As an alternative, such a fund would have to largely abstain from borrowing, thereby restricting its ability to leverage the fund in order to pursue a certain risk adjusted return objective.

Given the myriad of alternative strategies and accompanying risk mitigation practices, we urge the CSA to consider, for the purpose of calculating the total leverage exposure of an alternative fund, excluding the value of those specified derivatives and short sales that are used for hedging purposes.

Question 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.

Response

RPIA is of the view that an aggregate notional leverage limit does not provide investors with a fair and transparent view of the risks associated with leverage. We respectfully state that a risk based approach would result in a more relevant view and appropriate understanding of the risks facing alternative fund investors. A "one-size-fits-all" notional limit implies that the use of leverage results in the same level of risk to an investor, regardless of important contributing factors such as asset class risk and security specific risk. Investors are likely to view these risks in terms of the potential for capital losses related to a fund's use of leverage. The notion of leverage might be relatively unknown to many retail investors and can easily be misinterpreted and

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misunderstood in the absence of expert clarification. RPIA feels that it is vitally important to educate investors on the concept of leverage, and how risks associated with leveraged strategies can impact their overall investment risk profile, investment objectives and performance.

We note that risk can vary greatly between asset classes and between securities with differentiating characteristics. Applying leverage to these only magnifies this important distinction. In its simplified form, risk associated with leverage varies drastically, not only between asset classes such as equity and fixed-income, but between securities with varying characteristics. Examples of these could include fixed-income securities with different maturities and credit risk profiles. Leverage applied to investment grade fixed-income securities by nature would have a lower risk profile and potential for capital loss, than the same level of leverage applied to equities.

Other parts of the Canadian securities industry successfully apply risk based approaches to regulation and requirements. One prominent example of where a risk based approach is reflected, is in the investment dealer margin requirements prescribed by the Investment Industry Regulatory Organization of Canada ("IIROC"), in Rule 100 of the IIROC Dealer Member Rulebook. Although a discussion of these requirements go well beyond the scope of this letter, we would like to draw specific attention to the varying margin requirements that are based on the risks attributed to asset classes, security types and other security characteristics. For example, generally speaking, equities listed on an exchange in Canada or the U.S. for which margin is available (i.e. selling at $1.50 or more) require margin of between 50% and 80% of market value (excluding securities eligible for reduced margin). This can increase dramatically for securities listed in other countries, or for unlisted securities, and the margin requirement could represent multiples of the security's market value. This contrasts with fixed-income securities issued by the Canadian or U.S. governments that generally require margin of between 1% and 4% of market value. Additionally, prescribed margin requirements applicable to investment grade corporate fixed-income securities generically range between 3% and 10% of market value. We note that this example provides a very limited scope of the margin requirements under IIROC Rule 100. These requirements are subject to various conditions and can change or vary drastically depending on the nature of a security or the situation under which the margin requirements apply.

The rationale for referencing the IIROC margin requirements is to highlight the key importance of risk assessment in setting guidelines and restrictions. We realize that margin requirements do not, and should not necessarily form the basis of leverage restrictions for the purpose of the Proposed Amendments to NI 81-102, but we strongly and respectfully make the case that a "one-size-fits-all" notional limit is not appropriate and may not be in the best interest of investors. We urge the CSA to take these comments into consideration and to continue exploring risk based alternatives to setting leverage guidelines for alternative funds. RPIA will be pleased to contribute to any industry discussion that the CSA might see helpful in reviewing and assessing this material subject.

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RPIA would also like to draw attention to the view expressed by AIMA Canada that applying a nominal leverage limit is not appropriate, and that removing this limit would permit certain existing commodity pool funds to continue to operate, and very importantly, broaden the types of alternatives strategies available to retail investors. We would also support their recommendation that alternative funds be required, in the absence of an upper limit, to disclose their leverage and calculation methodology. An addition, RPIA agrees with AIMA Canada that there are multiple appropriate measure of leverage that can and should be used to address the variability of strategies across the alternative investment landscape.

Question 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.

Response

RPIA appreciates the importance of appropriate and relevant disclosure in Fund Facts documents and generally support the views expressed by AIMA Canada regarding this matter.

Part 2 - Additional Comments

1. Short Selling

a. Overall Limit

The Proposed Amendments will permit an alternative fund to enter into short positions with an aggregate value of not more than 50% of the fund's NAV. RPIA feels that although the limit is a very positive increase from the 20% applicable to existing funds under NI 81-102, it falls short of permitting several alternative investment managers from implementing specific investment strategies. Many alternative fund strategies rely on short selling as hedging to reduce certain risks. A notable example, and one that is detailed in the AIMA Canada comment letter, applies to funds that employ a market-neutral strategy, whereby long and short positions are balanced with the aim to negate market risks, so to allow the fund to pursue absolute returns, regardless of general market fluctuations. These strategies are used by

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sophisticated and institutional investors alike and present certain valuable risk and return opportunities. In order to successfully employ such a strategy, funds must have the ability to have short positions of up to 100% of NAV.

A second example builds on our earlier comments in Question 10 as it pertains to the short selling of government issued fixed-income securities for hedging purposes. As noted, this practice can be employed as an efficient way to hedge a portfolio holding investment grade corporate fixed-income securities, from the risks associated with general interest rate fluctuations. As a result, we request that the CSA consider increasing the overall permitted limit of these types of short sales. RPIA views this approach to be appropriately aligned with alternative funds that follow market-neutral approach.

Lastly, a focus of some alternative funds is to exclusively employ short selling strategies to generate leverage, and thereby largely refrain from using derivatives for this purpose. We note that permitting an alternative fund to employ leverage of up to 300% of NAV, while restricting its ability to engage in short selling to a lower limit, would likely compel those managers to change their investment strategies by engaging in derivatives transaction to generate sufficient leverage. This practice could lead to increased operational costs and complexities for certain managers, and may, in some instances have the unintended consequence of increasing undue risks related to the derivatives market.

b. Concentration Restriction

We acknowledge that under Section 2.6.1 of NI 81-102, the Proposed Amendments will increase the aggregate market value all securities of a single issuer sold short, to 10% of NAV.

As discussed earlier in this letter, RPIA utilizes hedging strategies in its private alternative funds that make extensive use of short selling to hedge against interest rate risk within fixed-income portfolios. The strategy has proved to be an effective way of achieving this objective and often does not require extensive use of the derivatives market. In particular, these strategies largely consist of holding investment grade corporate fixed-income securities while short selling government issued fixed-income securities. Such a strategy would not be implementable given the 10% issuer concentration restriction and will in turn, result in increased use of the derivatives market to achieve the desired hedging results. This again could result in operational complexities and may lead to additional risk exposure related to the use of derivatives.

We note that "government securities" as defined in NI 81-102 are excluded from the concentration restriction in Section 2.1 of NI 81-102. This is understandable given the nature and risk profile of these securities, and we strongly urge that the CSA consider applying the same exemption to the issuer concentration limits as it pertains to short selling. These government securities generally exhibit

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characteristics that result in them being regarded as some of the lowest risk and highly liquid securities available, and we believe that the risks associated with maintaining short positions in these do not present undue risk to investors.

2. Custodianship of Portfolio Assets

RPIA supports the comment made by AIMA Canada with regards to custody related matters under Part 6 of NI 81-102. In particular, we reference their comments regarding the seemingly unintended consequences of the custodial provisions related to short sales (Section 6.8.1 of NI 81-102). These restrictions will reduce the practicality of implementing short selling strategies in line with the Proposed Amendments, since it will likely lead to excessive costs and operational complexities. Furthermore, given the limited number of borrowing agents available in Canada for this purpose, this requirement may prevent otherwise permitted short selling activities of alternative funds.

We note that the comments made by AIMA Canada with respect to permitting prime brokers to act as custodians of alternative funds is of crucial importance. It will materially improve the operational efficiencies of alternative fund managers and will also provide an effective solution to the short selling custody related concerns noted above.

3. Counterparty Exposure Limits

RPIA echoes the view of AIMA Canada with regards to the counterparty exposure limit of 10% under Section 2.7 of NI 81-102. We agree that it is not clear that there is any undue risk from being exposed to a qualified counterparty that maintains a designated credit rating, as required by NI 81-102. We further note that the counterparty exposure limit does not currently apply to commodity pool funds under NI 81-104, and we do not agree with the elimination of this exemption under the Proposed Amendments for the purpose of alternative funds.

Conclusion

RPIA strongly believes that introducing regulation which would permit retail investors to access alternative investment strategies is, without doubt, an encouraging development within the Canadian investment fund landscape. We truly feel that these strategies, if employed in a suitable and appropriate fashion, will have a positive impact on the risk adjusted performance of investor portfolios. We stress that investor education will be paramount to ensure a clear and appropriate understanding of the risks associated with various types of alternative strategies. We conclude by stating that alternative investment managers should be governed by appropriate regulations that will permit them to employ their often unique strategies. Only by providing

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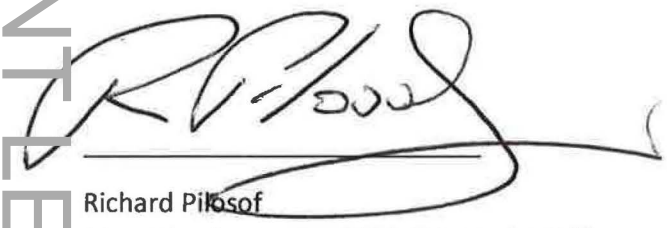
alternative managers with the ability to apply and demonstrate their expertise and value, will Canadian retail investors truly have access to the same alternative strategies currently reserved for institutions and other select investors.

We once again congratulate the CSA for their ongoing efforts and would be pleased to provide additional comments on the views expressed in this letter, or partake in further discussion with the CSA on this important matter.

Sincerely,



Richard Pilosof
Managing Partner and Chief Executive Officer

Mike Quinn
Partner and Chief Investment Officer

Manulife Asset Management

December 22, 2016

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

C/O:

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Dear Mesdames/Sirs,

Re: Canadian Securities Administrators' Notice and Request for Comment - Modernization of Investment Fund Product Regulation – Alternative Funds

Manulife Asset Management Limited is pleased to have the opportunity to provide comments on the Canadian Securities Administrators' ("**CSA**") Notice and Request for Comment – Modernization of Investment Fund Product Regulation – Alternative Funds (the "**Proposed Amendments**").

Capitalized terms used in this letter but not defined here have the same meaning given to them in the Proposed Amendments.

Overview

Founded in 1949, Manulife Asset Management Limited ("**MAML**") provides a range of investment fund products and a range of services including acting as portfolio manager and investment fund manager. These products and services may be provided in the name of MAML,

and/or one or more of its divisional trade names for external clients, including Manulife Asset Management and Manulife Investments ("**MI**").

Manulife Asset Management entities provide comprehensive asset management solutions for institutional investors and investment funds in key markets around the world. This investment expertise extends across a broad range of public, private, and alternative asset classes, as well as asset allocation solutions. Manulife Asset Management has offices with full investment capabilities in the United States, Canada, the United Kingdom, Japan, Hong Kong, Singapore, Taiwan, Indonesia, Thailand, Vietnam, Malaysia, and the Philippines. In addition, it has a joint venture asset management business in China, Manulife TEDA. It also has operations in Australia, New Zealand and Brazil. Manulife Asset Management Private Markets has investment expertise in several private asset classes, including commercial real estate, timberland and farmland, renewable energy, oil and gas, private equity and mezzanine debt. Manulife Asset Management Private Markets also partners with Manulife's specialized private asset investment teams to invest in private placement debt and commercial mortgages. Hancock Natural Resources Group, Manulife Real Estate, John Hancock Real Estate, NAL Resources, Regional Power, Manulife Capital, and Hancock Capital Management are units of Manulife Asset Management Private Markets.

As at September 30, 2016, assets under management for Manulife Asset Management were approximately C$450 billion.

Manulife Investments, a division of Manulife Asset Management Limited, builds on 125 years of Manulife's wealth and investment management expertise in managing assets for Canadian investors. As one of Canada's leading integrated financial services providers, Manulife Investments offers a variety of products and services including mutual funds, non-redeemable investment funds and structured products, and separately offers banking and insurance products through its affiliates.

As of September 30, 2016, Canadian mutual fund assets for Manulife Investments were approximately C$49 billion.

General Observations

We agree with the CSA that "the Proposed Amendments, if adopted, will have a meaningful impact on publicly offered mutual funds that utilize alternative strategies or invest in alternative asset classes (alternative funds) and would also affect other types of mutual funds (namely conventional mutual funds and ETFs) as well as non-redeemable investment funds", and are strongly supportive of efforts to modernize Canada's regulatory framework for investment funds and bring increased investment options to Canadian retail investors.

Although our primary comments are with regards to eligible asset classes and appropriate proficiency requirements, we are responding in turn to each of the questions posed by the CSA, as well as adding a select few other recommended improvements, as particularized below.

The questions are reproduced in bold for ease of review.

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 "non-conventional mutual fund" better reflect these types of funds?

Manulife AM Comment: We are supportive of the term "alternative fund", and note that it is similar to the term "alternative investment fund" used in the European Union for the regulation of a range of non-traditional fund asset classes, including hedge funds, commodity funds and real estate funds. This would be distinct from investment products using more traditional investment strategies to invest in stocks, bonds and/or or cash.

We are similarly supportive of the CSA's decision not to impose a naming convention for alternative funds that would require the use of "alternative fund" in the fund name.

As a further technical item, we agree with the comments made by the Alternative Investment Management Association ("**AIMA**") in recommending the following drafting clarifications to the proposed definition of "alternative fund":

"alternative fund means a mutual fund**, other than a precious metals fund,** that has adopted fundamental investment objectives that permit it to invest in asset classes**,** ~~**or adopt**~~ **use** investment strategies **or implement operational features that are not permitted by this Instrument** ~~**that are otherwise prohibited**~~ but for **certain** prescribed exemptions ~~**from Part 2 of**~~ **contained in** this Instrument;"

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.

Manulife AM Comment: We believe for the reasons below that both direct real property and non-guaranteed mortgages are common under typical alternative investment strategies and recommend they be made eligible investments under the alternative fund framework.

One solution may be to allow investors to access to these asset classes within the illiquid limits for alternative funds, while also allowing funds dedicated to these asset classes (e.g., "real estate funds") to have higher exposure and be subject to a different set of conditions. This latter concept would be similar to the ability of a precious metals fund under the Proposed Amendments to expose itself more broadly to commodities than other types of alternative funds.

Another option may be to allow for greater exposure to these alternatives, with more flexible illiquid limits, within an alternative fund of alternative funds and/or a multi-asset alternative funds (i.e., an alternative fund with multiple strategy 'sleeves', rather than multiple underlying funds).

Any alternative fund focused on direct real estate, mortgages, or other more illiquid assets would need higher illiquid limits, similar to the higher limits extended to Canada's segregated funds and remaining mutual funds in these categories.

In making these recommendations, we are cognizant that higher illiquidity brings higher risk of suspension of redemptions[1], as well as of Canadian regulatory efforts to treat funds with "active involvement" in the assets of the fund as non-investment funds[2]. In our view, neither of these points are sufficient to warrant blocking Canadian retail investors from making an informed decision to accessing these asset classes in alternative funds, or in alternative funds of funds, when suitable to their investment needs.

a. **Real Property**

The three primary arguments in favour of direct real estate are:

i. **Improved Diversification:** A key benefit of investing in real property as an asset class is improved portfolio diversification. This asset class has historically generated returns that tend to exhibit low correlation relative to the returns for traditional equity and bond investments, as the supply and demand fundamentals of real estate are not directly tied to the demand for these other financial assets. As a result, adding exposure to real property to a diversified portfolio can potentially improve the risk-adjusted returns of the portfolio as well as potentially decrease overall portfolio volatility.

   We also note that investing in real estate stocks (that is, equities of issuers engaged in the real estate industry) does not provide the same benefits as gaining more direct exposure to real property. Real estate stocks are typically more highly correlated to the broader equity market than real property assets are themselves, which reduces the diversification benefits discussed above. Real estate stocks are typically affected by a number of variables other than the value of the real property assets they are developing, holding, operating or managing, and therefore may not directly track the value of the real property assets. For example, the stocks of real estate companies may be affected by their capital structure, management and business-related activities.

ii. **Inflation Protection:** Investing in real property as an asset class has historically proven to be beneficial in certain market environments. For example, real estate has

[1] Please see our responses to question 5 for a brief discussion on tools that can help mitigate liquidity risk.

[2] For example, section 1.2 of Companion Policy 81-106 reads that "...an investment fund does not seek to invest for the purposes of exercising or seeking to exercise control or being actively involved in the management of any issuer". Active involvement has been interpreted in ways including focussing on the originator's sourcing efforts, property management, etc.

been positively correlated with rising inflation, as real estate valuations have historically risen when inflation is increasing. As other asset classes may decline during inflationary periods, having even the option to opportunistically expose a portion of a fund's assets to real property may help the fund and its investors preserve capital and maintain purchasing power in an inflationary environment.

iii. **Potential Performance Enhancement:** For the reasons discussed above, the option of allocating even portion of a fund's assets to direct real property will not only increase diversification opportunities but can also improve the Fund's overall risk/reward profile.

In considering whether real estate might be appropriate in an alternative fund, we made the following further observations regarding access to real estate by Canadian retail investors, as well as retail investors abroad:

iv. **Exemptive Relief under NI 81-102 – Investors Real Property Fund:** Canadian securities regulators, including the OSC, have previously granted extensive relief from the provisions of NI 81-102 in order to permit a Canadian retail mutual fund governed by NI 81-102, namely the Investors Real Property Fund managed by I.G. Investment Management, Ltd., to directly purchase, hold, manage and operate a portfolio of real property (see *I.G. Investment Management, Ltd. (April 18, 2007)* and *I.G. Investment Management, Ltd. (May 26, 2009)*).

According to the fund's 'fund facts' dated September 26, 2016, this fund appears to have been operating at least as early as January 1984 (almost 23 years), and had assets of $5.5 billion as at July 31, 2016. It is clear based on public disclosure documents that many of the retail mutual funds managed by I.G. Investment Management, Ltd. have invested significant portions of their net assets in securities of the Investors Real Property Fund and that, as a result, a significant number of the issued and outstanding securities of the Investors Real Property Fund are in aggregate held by those retail funds. For example, the Alto Monthly Income Portfolio, a fund-of-funds product managed by I.G. Investment Management, Ltd., discloses in its fund facts dated September 26, 2016 that 9.9% of its assets were invested in securities of the Investors Real Property Fund as at July 31, 2016, and that it generally provides 10% exposure to the Investors Real Property Fund.

In our view, this fund's 20+ years demonstrates that the needs of retail Canadians can be served within an investment fund regulatory framework inclusive of appropriate guidelines, and would be supportive of further similar offerings being allowed as alternative funds only.

v. **Exempt Market - Canadian Real Estate Pooled Funds:** Real estate fund offerings can generally be made to 'mass affluent' individual Canadians who are not accredited investors or otherwise exempt, but who rely on the offering memorandum exemption in section 2.9 of NI 45-106. This would include "eligible investors" whose net assets alone or with a spouse exceed $400,000, or whose net income exceeds $75,000, or a

net income of $125,000 with a spouse. While the requirements of this exemption vary by Province and Territory, conditions of reliance on this exception generally include the provision of an offering memorandum in a prescribed format and the signing of a risk acknowledgement.

Regulators are encouraged to consider the alternative funds framework as an opportunity to further standardize and enhance disclosure and other obligations for real estate funds (e.g. independent review committee oversight), similar to the prospectus-qualified Investors Group fund discussed above.

vi. **Real Estate is Permitted for Canadian Individual Retail Segregated Fund Policy Holders:** Any Canadian who cannot access a diversified portfolio of direct real estate in a mutual fund or pooled fund can do so in a segregated fund[3], though they may not want or need the insurance guarantee features these products can provide.

vii. **Real Estate Investment Flexibility was Increased in Canadian Pension Rules:** Recognizing the benefits real estate can offer to pension plans, pension regulators in recent years eliminated the real estate investment quantitative limits formerly in s. 10 of Schedule III of the *Pension Benefits Standards Regulations, 1985*.

viii. **Many European Retail Investors Can Invest in Real Estate Funds:**

In many European jurisdictions, real property is a common asset class to be held in funds available to retail investors. Examples of unlisted vehicles for retail investors where the primary investment strategy is to invest in property include[4]:

France

France allows investment by individuals in real estate collective investment undertakings (*Organismes de Placement Collectif Immobilier* or "**OPCI**") – unlisted property investment vehicles managed by authorised fund managers and which are set up as either a company or a real estate fund. There are no restrictions on the type of investor. OPCIs are governed by the French monetary and financial code (MFC) implementing the Alternative Investment Fund Managers Directive ("**AIFMD**") into French law and the General Regulation of the *Autorité des Marchés Financiers*). Because they are open to retail investors, OPCIs are subject to specific rules, notably in terms of eligible assets, risk limits and investment ratios. In addition, there are provisions for the marketing and sales to retail investors, such as the obligation to provide key investor information, prospectus and annual reports.

Germany

[3] See Canada Life and Health Insurance Association Inc. *Guideline G2 – Individual Variable Insurance Contracts Relating to Segregated Funds* (the "**CLHIA Guidelines**"), sections 9.1 and 9.5.
[4] With thanks to Ashurst LLP for their European investment law research on point.

Germany allows investment by individuals in investment funds including open-ended and closed-ended real estate funds. There no restrictions on the type of investor but limits on the assets and real estate companies that may be acquired in accordance with the German Capital Investment Code ("**KAGB**") or AIFMD as well as on leverage and risk spreading. In addition, there are provisions for the marketing and acquisitions with regard to retail investors in accordance with KAGB/AIFMD, e.g., duty to provide the retail investor with key investor information, prospectus and annual reports as well as publication duties and ongoing information duties.

Luxembourg

Luxembourg similarly allows investment by retail individuals in "Part II Funds" – collective investment undertakings subject to the Part II of the Luxembourg "2010 Law". Interests in Part II Funds can be sold to any type of investor, i.e. institutional, high net worth and retail investors. These funds must comply with diversification investment restrictions (generally five different investments), and requirements to prepare detailed constitutional and offering documents and an annual report. The fund and all the fund documentation is subject to prior Commission de Surveillance du Secteur Financier approval and ongoing supervision.

Spain

Spain similarly allows investment by retail individuals in a real estate investment fund or company (*Fondos de Inversión Inmobiliaria, Sociedad de Inversión Inmobiliaria* or "***FII – SII***"). There are no restrictions on the type of investor in a FII or SII as specifically designed for retail investors. Restrictions are placed upon its investment strategy, and risk diversification. NAV must be calculated at least monthly, and participations can be subscribed or redeemed at least once a year.

United Kingdom

Broadly, the UK allows investment by individuals in retail investment funds that invest primarily in direct property (and other illiquid assets) in 'Non-UCITS retail schemes' ("**NURS**") managed by authorised fund managers. There are no restrictions on the type of investor in a NURS as specifically designed for retail investors. Restrictions are placed upon its investment strategy, including a limit on the percentage of assets that can be held in one investment (full restrictions set out in the Collective Investment Schemes Sourcebook Chapter 5).

***

Again – if retail investors can access direct real estate in an unlisted real estate fund in these countries, we encourage the CSA to consider similarly allowing direct real estate in an alternative fund in Canada, subject to appropriate conditions.

b. **Non-Guaranteed Mortgages**

As many of our arguments in favour of non-guaranteed mortgages replicate our arguments for real estate, we offer them in brief followed by additional information regarding the Canadian commercial mortgage market generally.

An ability to accessing these mortgages directly can improve income diversification, as well as returns, and the performance of these mortgages is not the same as guaranteed mortgages (the returns are generally higher as a further risk premium is earned relative to mortgages with government guarantees) or any listed mortgage vehicle (the performance of which will be more directly impacted by the performance of the broader market).

Canadian retail investors looking for commercial mortgage fund exposure are facing diminishing investment fund options, as only existing NI 81-102 funds meeting the grandfathering exceptions of s. 20.4 of NI 81-102 can be offered, with the Proposed Amendments narrowing mortgages in non-redeemable investment funds even further. As a result, they may need to look to either (a) the exempt market; or (b) mortgage segregated funds that offer guarantees they may not need[5].

Similar to real estate, we believe non-guaranteed mortgages are an appropriate class for consideration in an alternative fund framework, and that Canadian retail investors should be able to benefit from, where suitable.

General Information regarding Canadian Commercial Mortgage Market

The Canadian commercial mortgage market provides a source of financing for real estate properties in Canada across a diverse group of property types and geographic regions. Commercial mortgage issuance is predominately investment grade however it spans across the full credit quality spectrum.

Terms to maturity generally range from 1 year to over 10 years with amortization periods ranging from fifteen to thirty years with twenty-five years being the most common and some interest only loans on a case by case basis. Loan repayments are received on a monthly basis for the term of the mortgage, most often in a blended form of principal and interest with the outstanding principal balance due at the end of the mortgage's term.

The leading participants in the commercial mortgage market include primarily banks, insurance companies, pension funds, conduit lenders, credit unions and private groups. Lenders either source investment opportunities from borrowers directly or through the mortgage brokerage community.

[5] Please see sections 9.1. and 9.6 of the CLHIA Guidelines for the rules generally governing mortgage segregated funds offered under individual variable annuity contracts.

Like a bond, a commercial mortgage is a fixed instrument that is used to secure the repayment of a loan for funds advanced to a borrower. Security for these loans is a registered charge against income-producing property. The primary types of income producing assets held as security by commercial mortgage lenders are retail, office, industrial and multi-family properties. Hotels, senior housing facilities, self storage facilities, land and manufactured home communities are less prominent properties that are also used as security for commercial mortgage loans.

The amount of a commercial mortgage available to a borrower is driven by two key ratios: loan-to-value and debt service coverage. Institutional lenders have traditionally lent to a maximum of seventy-five percent of the estimated market value of the property while ensuring that the net operating income generated by the property is sufficient to cover the annual debt service obligations created by the mortgage of a ratio of typically not less than 1.20 times. Adherence to these ratios generally provides certain capital and cash flow downside protection should the property and /or owner, experience unexpected market and /or credit events during the course of the loan's term.

Pricing of a commercial mortgage has two components: the yield on a term-equivalent Government of Canada bond and a credit spread. Historically, commercial mortgage credit spreads have averaged around 150 basis points with the actual spread being a reflection of the strength and quality of the commercial mortgage loan and if applicable guarantor entities, property characteristics (property type, location, tenants, leases, vacancy rate and income), transaction metrics (loan to value and debt service coverage ratios), and prevailing market conditions.

A higher spread or coupon for a commercial mortgage relative to a similarly rated public bond is primarily compensation for the lower liquidity offered by commercial mortgages relative to a public security and often reflects the ability to negotiate terms, structures, and covenants, rather than in an auction process, as is the case in the public bond market. Cash flow is generally fixed rate and closed to prepayment. Prepayments may be accepted with yield maintenance calculated on a discounted cash flow basis typically based upon the Government of Canada bond yield.

Commercial mortgages also generally offer a higher level of security than many other alternative fixed income products. The security behind the majority of bond issues relies on the good faith and credit of the issuer. In the event of a default, bond indentures do not entitle the lender to attach a claim to a specific asset owned by the borrower. Bondholders are considered general creditors, ranking in priority just ahead of common stock holders. Recovering on general creditor debt is dependent on liquidated value of the borrowing entity after all of the secured creditors (including mortgage holders) have been satisfied.

Mortgage lenders, on the other hand, hold a priority charge against specific fixed assets. In the case of a default on a mortgage loan, the lender may look to the borrower (for mortgages that have recourse provisions) as well as the property and its cash flow for repayment, and has a range of mortgage default remedies to help maximize the likelihood of recovering the full amount of the outstanding loan.

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.

Manulife AM Comment: We generally have no objection to a 20% concentration limit for alternative funds, and would not object if no hard cap was imposed, similar to the 10% concentration limit for conventional mutual funds, which has no hard cap.

We further echo AIMA's argument that any hard cap runs the risk of triggering forced sales, "as quickly as commercially reasonable", which may be at times of distressed prices or otherwise not be in the best interests of investors in the fund.

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.

Manulife AM Comment: Yes. As noted above, many alternative funds use strategies such as real estate, mortgages, and private debt with higher illiquid limits for investors who have longer time horizons and who can otherwise satisfy their liquidity needs from their other investments and liquid assets.

As noted above, other retail-oriented regimes in Canada and abroad have allowed such products to have different illiquid standards to enable retail clients to have access to such asset classes, subject to appropriate conditions, including liquidity and disclosure obligations.

In support of this point, we echo the facts raised by the Investment Funds Institute of Canada ("**IFIC**")[6], that U.S. conventional mutual funds are allowed to invest 15% of their assets in illiquid assets, which we think Canadian conventional mutual funds should be allowed to follow. We would also encourage higher illiquid limits (up to 20%) in alternative funds.

As a separate point, we separately acknowledge the industry comments on certain technical challenges in the definition of "illiquid asset" in NI 81-102, and in particular encourage adoption of the clarifications being articulated by the Portfolio Management Association of Canada ("**PMAC**"), which revises the definition to:

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[6] For ease of reference, IFIC's submissions include: "We encourage the CSA to consider adopting a higher time of purchase limit for alternative funds. In 1992 the U.S. Securities and Exchange Commission increased the permitted level of mutual fund investments in illiquid assets from 10% to 15% of NAV[6]. At the time U.S. small businesses were finding it increasingly difficult to obtain financing from banks and similar traditional sources. It was felt that allowing mutual funds to invest an additional 5% of their net assets in illiquid securities could make a significant amount of capital available to small business without significantly increasing the risk to any fund. Assessing the experience of U.S. mutual funds over the decades since this limit was increased should provide sufficient evidence that a similar increase for alternative funds in Canada is unlikely to significantly increase the risk to these funds."

"illiquid asset" means:

(a) a portfolio asset that cannot be readily disposed of through market facilities on which public quotations in common use are widely available (which include over-the-counter-markets) at an amount that at least approximates the amount at which the portfolio asset is valued in calculating the net asset value per security of the investment fund;

(b) a restricted security (other than a government or corporate bond) held by an investment fund;

Finally, we acknowledge the CSA's guidance with regards to liquidity that "...[the CSA] continue[s] to stay abreast of the various initiatives on liquidity risk management for investment fund products at the international level and how this may impact our work on this stage of the Modernization Project." (September 22, 2016 OSC Bulletin p.8054; all OSCB page references in this letter are to this bulletin).

As a global asset manager, we strongly encourage global harmonization of appropriate investment fund standards to achieve common levels of investor protection, simplify administration and reduce costs.

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.

Manulife AM Comment: Yes. Generally, the less frequent redemptions are, the less the liquid needs of the fund in the ordinary course.

Many institutional funds offer access to alternative asset classes at redemption frequencies that are monthly or annual, or have lengthy notice periods for redemption, to seek to maximize potential investment returns in illiquid assets and reduce the risk that assets will need to be liquidated in unfavourable market conditions, or that redemptions may need to be suspended.

Some of the tools used by the funds to help mitigate liquidity risk include leveraging assets or borrowing from lines of credit and other sources.

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*).

Manulife AM Comment: We agree that investors in exchange-traded non-redeemable investment funds have lower liquidity needs from their fund's investment assets relative to conventional mutual funds and alternative funds, as they can sell their fund to another investor on the exchange, rather than only being able to redeem it.

As a result, we agree with industry feedback that the illiquid limits of exchange-traded non-redeemable investment fund can and should be much higher and would be supportive of continuing to have no illiquid limits being imposed on these non-redeemable investment funds.

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.

Manulife AM Comment: Yes. Again, generally, if a fund does not have to redeem at a specific asset valuation, there should be a higher tolerance for illiquids.[7]

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.

Manulife AM Comment: We agree with past comments by others "that limiting borrowing to Canadian financial institutions would reduce competition and possibly increase borrowing costs" (OSCB p.8083).

As a factual matter, two of our non-redeemable investment funds currently have borrowing arrangements with a U.S. subsidiary of a Canadian Schedule I bank. The borrowing is denominated in U.S dollars as the borrowed monies are used to buy U.S. securities for primarily U.S. mandates. If the borrowing restriction is implemented as proposed, we will no longer be able to borrow from this lender.

The CSA is aware of the higher qualification requirements for foreign sub-custodians, relative to Canadian custodians, as set out in section 6.3 of NI 81-102. We encourage the CSA to clarify its rationale for restricting behind wanting to restrict borrowing to Canadian lenders, and consider

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[7] We also agree with AIMA's responses to this question, which reads: "Generally speaking, we submit that liquidity is of little relevance or concern where an alternative fund or a non-redeemable investment fund have limited redemptions and of no relevance or concern where such a fund is not redeemable. Our view is consistent with International Organization of Securities Commissions ("IOSCO") principles on liquidity. The alignment of liquidity with the redemption obligations and other liabilities of open-ended funds is a principle recommended in IOSCO's "Principles on Suspensions of Redemptions in Collective Investment Schemes" [available at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD367.pdf] and reiterated in a report published in March 2013 entitled "Principles of Liquidity Risk Management for Collective Investment Schemes" in which they recommended fifteen principles [available at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD405.pdf.]"

whether any higher requirements for foreign lenders (similar to the higher requirements on foreign sub-custodians) might mitigate these concerns.

In the alternative, if the CSA is unwilling to allow borrowing from lenders globally due perhaps to the perceived risks of borrowing from lenders in certain countries, we encourage the CSA to allow borrowing from U.S. lenders under conditions similar to s.6.2 of NI 81-102.

We note that NI 81-102 already has a number of special provisions for the U.S. inclusive of the definition of "government security" (the government of the United States of America is the only foreign government in this definition) and "index participation unit" (the only permitted foreign exchanges are in the U.S.), and respectfully request that the CSA again consider the U.S. in light of the protections offered by its robust legal and regulatory systems.

As a separate point, we understand many alternative fund strategies (e.g., hedge funds) commonly rely on the services of a prime broker, who may not meet the custody standards in s. 6.2 of NI 81-102. We encourage further analysis to ensure that the rules for alternative funds are sufficiently flexible to access these key service providers, and in particular, to the comments submitted by AIMA on prime brokers.

As a final general borrowing point, we encourage the CSA to consider whether paragraph 2.6(a)(i) might be further expanded for temporary measures to accommodate requests for redemptions of alternative funds and conventional mutual funds. The purpose of reconsidering the paragraph would be to enable the fund to avoid or minimize overdraft or other expenses that may be incurred by the fund in satisfying higher than usual levels of redemption demand.

We understand that other countries such as the United States allow conventional mutual funds to borrow from one another under set conditions to mitigate conflicts, at a competitive rate that is lower than that of custodian overdraft charges, and beneficial to both the lending and borrowing funds. Such interfund lending tools are also desirable as there is no guarantee that custodian overdraft facilities will be available to accommodate redemption needs, particularly in distressed market environments.

To the extent conventional mutual funds are holding relatively more illiquid assets, it would also be useful to offer them the further borrowing tool allowed in *Alphapro Management Inc. (May 29, 2015)*, an exemption which allowed a senior loan fund to borrow cash up to 10% of NAV as a temporary measure to accommodate requests for redemption of units. That relief was granted, subject to numerous conditions, in recognition of the longer settlement times of senior loans.

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.

Manulife AM Comment: We have no comments on this item at this time.

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?

Manulife AM Comment: We are supportive of AIMA's encouragement of the CSA "...to either: (i) remove the 300% of NAV leverage limit from section 2.9.1 and to require disclosure of the amount of leverage and the method used for calculating leverage by the alternative investment; or (ii) allow alternative funds to subtract or disregard certain offsetting or hedging transactions (such as currency hedges) in specified derivatives that do not create leverage."

If the latter, we are also supportive of the recommendations of AIMA, IFIC and PMAC to exclude from leverage calculations any hedging derivative transactions. We are similarly supportive of excluding hedging short sales activities (at least of government securities), and offsetting transactions, to reduce calculated leverage exposure.

We recognize the CSA's comments regarding Value at Risk ("**VaR**") measures, which reads "...although the value-at-risk is quite a comprehensive measure it may not be a straightforward method of calculation and can be somewhat subjective in its elements" (OSCB 8075). As the CSA has indicated it is nonetheless welcoming "specific feedback on appropriate methodologies", we do wish to confirm our willingness to use the Value-at-Risk methodologies that we use abroad for the reasons below as well as part of our desire, as a global asset manager, to efficiently manage these risks consistently across borders.

The following is adapted from submissions made earlier this year by our affiliates, John Hancock Advisers, LLC and John Hancock Investment Management Services, LLC (collectively "**John Hancock Investments**") to the U.S. Securities and Exchange Commission ("**SEC**") regarding *Use of Derivatives by Registered Investment Companies and Business Development Companies.*[8]

> John Hancock Investments recommended the SEC consider "...the adoption of a principles-based risk management framework, in lieu of rigid portfolio limitations. Under this approach, a fund could elect to comply with one of two VaR-based regimes similar to the guidelines applicable to UCITS funds: (i) a Relative VaR approach, pursuant to which the VaR of a fund's entire portfolio may not exceed the VaR of a reference portfolio by greater than a set measure; or (ii) an Absolute VaR approach, pursuant to which the VaR of a fund's derivatives portfolio may not exceed a defined amount...of the fund's net assets under management.
>
> [John Hancock Investments wrote] that the VaR regime is superior to the proposed portfolio exposure limits for several reasons. First, the VaR regime would likely have an even more limiting effect on the ability of registered funds to enter into significant directional leverage than would the portfolio limitations described in the Proposed Rule. Second, a principles-based risk management framework such as the VaR regime does not suffer from the perverse incentives and unintended consequences of the portfolio limitations described

[8] More specifically, the submissions address the SEC's proposed rule 18f-4 under section 18 of the *Investment Company Act of 1940* (the "**Proposed Rule**").

herein[9]. Third, the VaR regime appropriately distinguishes between derivative transactions that increase portfolio risk and those that reduce portfolio risk. Fourth, rather than assessing the notional exposure of derivatives, which is an imprecise proxy for whether leverage actually increases risk, the VaR regime ***actually assesses the extent to which leverage increases the speculative character of a fund***. In these respects, the VaR regime is both a more effective means of measuring and managing a fund's derivatives risk and more closely related to the undue speculation concern expressed in section 1(b)(7) of the 1940 Act.

[John Hancock Investments recognized] that the VaR regime, considered in a vacuum, does have certain drawbacks. The [SEC] cites as one drawback the difficulty in selecting an appropriate benchmark for a relative VaR test. However, as discussed above, a relative VaR test could be based on endogenous characteristics of a fund's portfolio rather than an external benchmark. If the [SEC] adopts a VaR regime that does not require any reference to an external benchmark, this concern would be entirely moot. The [SEC] also cites as a drawback of the VaR approach the possibility that a fund could obtain enormous offsetting exposures and still pass either VaR test described above. However, we believe this concern is mitigated by the other provisions of the Proposed Rule. The qualifying coverage regime of the Proposed Rule effectively limits this possibility by requiring that a fund earmark a risk-based coverage amount with respect to each derivative transaction entered into by the fund."

We are not recommending any changes to the definition of "hedging" at this time, though would welcome any further calculation clarity to ensure consistent interpretation. For example, we are aware of at least one law firm advising that the definition's requirement of "a high degree of negative correlation" should be taken to mean "approximately 75-80% negative correlation over at least a three-year period".

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.

Manulife AM Comment: Like AIMA, we generally agree that the notional amount doesn't necessarily "...reflect the way in which the fund uses the derivative and that it is not a direct measure of risk."

We again echo the comments of John Hancock Investments to the SEC in their submission that:

"...gross notional exposure is rarely an accurate reflection of the market exposure created by a derivative instrument because the cash flow obligations under most derivatives are a small percentage of notional exposure. For example, the volatility of most interest rate derivatives is much lower than the volatility of equity derivatives....

The two most obvious consequences of portfolio limitations based on a simplistic calculation of notional exposure are constraints on the ability of fund managers to (i) reduce or manage the risks of fund

[9] One of the "perverse incentives and unintended consequences" cited included that "...the Proposed Rule may incentivize fund managers to use derivatives with higher risk profiles and lower notional exposure to manage or reduce the risks of fund portfolios in an effort to comply with portfolio limitations..."

> portfolios through the use of derivatives (particularly derivatives with low volatility profiles), and (ii) use derivatives to obtain synthetic exposure to securities or other assets. Reducing the risk management options available to fund managers will result in portfolios with higher risk profiles. Likewise, the impact of limiting or removing the ability to express investment strategies through synthetic exposures in fund portfolios is a lost opportunity to reduce risks related to liquidity, valuation, and transparency that can arise from holding certain physical positions. It is possible that the portfolio limitations in the Proposed Rules will reduce risks in certain portfolios that engage in directional leverage, but they will also increase risk in portfolios of funds that use derivatives for risk management and risk reduction. In other words, for funds employing low risk investment strategies, the Proposed Rule as written effectively reduces risk management options for funds which may decrease the fund's expected return or increase its risk to achieve that level of return."

We would be pleased to share our affiliates' entire submission to the SEC upon request.

Our views in support of VaR are outlined in response to question 10.

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.

Manulife AM Comment: We have no comments on this item at this time for non-redeemable investment funds, beyond those we have made elsewhere in this letter.

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.

Manulife AM Comment: Similar to past releases of proposed fund facts documentation, we strongly encourage the CSA to issue a sample fund facts for alternative funds to review and comment on. The development of such a sample often yields insights to practical challenges in document development or investor experience that may not otherwise be obvious, and serves as further helpful guidance to the industry on regulatory expectations.

In the interests of keeping the Fund Facts brief and readable, we also believe there should be no Fund Facts disclosure obligation to contrast alternative funds with conventional mutual funds. A Fund Facts for an alternative fund should inform investors by telling them what it is, without having to tell them what it is not. Also, in furtherance of our response to Question 14 below, we

would discourage any mandated disclosure implying a blanket "high risk" for all alternative funds regardless of the risk level of the particular fund described in the Fund Facts.

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?

Manulife AM Comment: While standard deviation is not without shortcomings, we are supportive of using standard deviation for alternative fund risk classification as a consistent methodology across all investment funds.

We are currently reviewing the final risk rating methodology guidance published December 8, 2016, and still considering its applicability to alternative funds, but note IFIC's comments that:

> "There is much more work to be done before the [final risk rating] methodology [released on December 8, 2016] can be applied to alternative funds. For instance, the Canadian Investment Funds Standards Committee ("CIFSC") currently has only one general "catch-all" category for funds that apply "alternative strategies". This is due primarily to the current heterogeneity of the investment strategies applied by those funds, making it difficult to compare one fund with its peers. IFIC's Fund Categorization Working Group is considering the best categorization approach to recommend to CIFSC for these funds. It is our hope that fund managers not apply their own individual criteria to the alternative funds they manage. Similarly, as the CSA has already acknowledged, applying a blanket classification of "high risk" to all of these funds, without further analysis, is inappropriate."

One area that we will be particularly focused on is the "use of discretion", which "...only allows a fund manager to classify a mutual fund at a higher investment risk level than indicated by the quantitative calculation", and questioning whether some further interim flexibility is warranted for alternative funds.

Different types of alternative funds can have meaningfully different risk and return characteristics, not only relative to each other, but in isolation over time. We encourage the CSA to ensure the final version of the Proposed Amendments includes clear rules regarding the use of the CSA's risk classification methodology for alternative funds. This would permit alternative fund managers to adopt the CSA's risk classification methodology at the outset, rather than

having to switch methodologies and disclosure after the first alternative funds Fund Facts have been filed and delivered.

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.

Manulife AM Comment: We have no comments on this item at this time.

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.

Manulife AM Comment: We have no objections to the proposed transition periods.

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Other Comments

In addition to our comments above, we respectfully submit the following additional comments:

1.**Ability of Conventional Funds to Only Invest 10% in Alternative Funds**

The CSA noted that the proposed amendments help facilitate more alternative and innovative strategies while at the same time maintaining restrictions believed to be appropriate for products that can be sold to retail investors. With this in mind, the CSA has proposed a conventional mutual fund's aggregate exposure to alternative funds is limited to 10%.

We respectfully submit that, to help encourage conventional retail funds' access to innovative strategies, consideration should be given to increasing the limit up to 20%. This increase is particularly desirable for an investor seeking exposure to asset classes and/or investment strategies through portfolio solutions rather than stand-alone mutual funds.

2. **Mutual fund dealer salesperson proficiency requirements for alternative funds**

In the Proposed Amendments, the CSA advised it "...will be working with the MFDA to come up with the best solution to [appropriate proficiency requirements for mutual fund dealer salespersons] ..., have not proposed any changes to the proficiency requirements for IIROC registrants..., [and]...welcome any specific feedback on the Proficiency Requirements in light of the Proposed Amendments" (this, and all subsequent quotes in this section, are from OSCB p. 8078- 8079).

While we place high value on appropriate registrant proficiency to help deliver investor protection, we note with concern, that one past commenter to the CSA had suggested that "...the CSA should consider Chartered Financial Analyst, Chartered Investment Manager or Chartered Alternative Analyst designation as proficiency standards for representatives dealing in alternative funds".

We hope to see retail Canadians be able to appropriately take full advantage of the new investment options that alternative funds can deliver, when suitable to their needs. As a result, we respectfully encourage careful consideration of appropriate proficiency levels for mutual fund dealer salespersons, to ensure these levels are not needlessly raised to a point that effectively restricts much retail investor access to alternative funds.

In considering the appropriate proficiency requirements, we noted the following:

a. *Conventional Mutual Funds Can do Most Things an Alternative Fund Can*

Under the Proposed Amendments, most of the differences in investment 'tools' between a conventional mutual fund and alternative funds are differences in the extent to which a particular strategy can be used, as opposed to whether they can be used at all.

For example, alternative funds are allowed higher limits for concentration restrictions, commodity investments, investments in underlying alternative funds, shorting and more flexibility in derivative usage.

As we presume these existing investment tools in conventional mutual funds are able to be well understood within existing proficiency requirements, we see no justification to materially increase proficiency requirements merely because these tools are being more significantly used.

As there are many similarities between conventional funds and alternative funds, we suspect existing investment fund courses could be updated to include alternative funds content. That said, we appreciate existing mutual fund salespersons will need training on alternative funds including how they are different from other types of funds.

b. *Mutual Fund Dealer Salespersons Are Trained in the Risks of Borrowing and Leverage*

The starkest differences between conventional and alternative funds are the strategies that generally conventional funds cannot do at all, namely borrowing and leverage. We recognize the significant extent to which these two tools can be used in alternative funds, which can have a very meaningful impact on fund performance.

We believe all mutual fund dealer salespersons should already have a strong understanding that such tools can magnify investment gains or losses, as part of their training on the risks of borrowing to invest. As a result, we do not believe significant additional proficiency requirements are warranted to understand these tools in an alternative funds context.

c. *"Know your Product" Reviews of Alternative Funds likely to be More Robust*

We believe alternative funds will generally be more complex in nature than conventional mutual funds, and will warrant further know your product ("**KYP**") scrutiny to ensure proper understanding. MFDA guidance on KYP expectations for alternative funds may further mitigate any perceived need for material additional proficiency requirements.

d. *Significant Additional Proficiency Requirements Can Significantly Limit Distribution Channels*

Though MAML has never offered commodity pools, there is a general belief within our Product and Legal teams that part of the reason why so few firms offered commodity pools was because of the significant additional proficiency requirements for mutual fund sales representatives and their supervisors in Part 4 of NI 81-104.

In brief, under NI 81-104, the sales representative would have to pass any of the Canadian Securities Course, Derivatives Fundamentals Course, Chartered Financial Analyst ("**CFA**") Program, or a proficiency standard set by a self-regulatory organization. Other courses commonly taken by mutual fund dealer salespersons, such as the Canadian Investment Funds Course Exam or the Investment Funds in Canada Course Exam, would not suffice.

The supervisor has the relatively tougher standard to meet in that they have to either pass the Derivatives Fundamentals Course or CFA program.

As many salespersons and/or their supervisors did not have these courses, and for whatever reason did not obtain them, this undoubtedly impacted access to commodity pools, which in turn impacted the number of commodity pools launched and assets raised.

We looking forward to reviewing the proposed proficiency requirements for alternative funds in due course.

3. **Conventional Funds - Derivatives – "Designated Rating"**

The CSA's counterparty risk commentary in the Proposed Amendments (OSCB p.8071) included a recognition that "there are now fewer counterparties that...meet the "designated rating" threshold" set out in NI 81-102.

We agree that there are fewer counterparties meeting this threshold following the global financial crisis, and respectfully recall past law firm notifications from 2011 about prominent financial institutions such as Bank of America, Goldman Sachs, Citigroup, Morgan Stanley and Merrill Lynch & Co. Inc. each being downgraded by one or more designated rating organizations to below the designated rating threshold for long-term debt set out in NI 81-102, and therefore being - at least temporarily until their ratings improved - ineligible as counterparties for longer-term derivatives.

To access a wider array of counterparties and ensure robust competition, while still addressing

counterparty risk by ensuring the counterparty is investment grade, we recommend considering aligning the definition of "designated rating" in NI 81-102 with the definition of "designated rating" in NI 44-101.

For ease of reference, under NI 81-102, "designated rating" means, "...for a security..., a rating issued by a designated rating organization, or its DRO affiliate, that is at or above one of the following rating categories, or that is at or above a category that replaces one of the following rating categories, if:

(a) there has been no announcement by the designated rating organization or its DRO affiliate of which the mutual fund or its manager is or reasonably should be aware that the rating of the security or instrument to which the designated rating was given may be down-graded to a rating category that would not be a designated rating, and

(b) no designated rating organization or any of its DRO affiliates has rated the security or instrument in a rating category that is not a designated rating:

Designated Rating Organization	Commercial Paper/ Short Term Debt	Long Term Debt
DBRS Limited	R-1 (low)	A
Fitch, Inc.	F1	A
Moody's Canada Inc.	P-1	A2
Standard & Poor's Ratings Services (Canada)	A-1 (low)	A"

By contrast, under NI 44-101, "designated rating" means, "...for a security, a rating by a designated rating organization, or its DRO affiliate, that is at or above one of the following rating categories or that is at or above a category that replaces one of the following rating categories [ratings for preferred shares excluded]:

Designated Rating Organization	Short Term Debt	Long Term Debt
DBRS Limited	R-2	BBB
Fitch, Inc.	F3	BBB
Moody's Canada Inc.	Prime-3	Baa
Standard & Poor's Ratings Services (Canada)	A-3	BBB"

The CSA will appreciate in comparing the two definitions that the latter definition not only includes lower investment grade thresholds, and requires only one qualifying rating from a designated rating organization, it also eliminates the obligation to treat potential downgrade announcements by designated ratings organizations as effective.

In the alternative, if the CSA is unwilling to adopt a credit rating as low as BBB, we would be supportive of an NI 44-101 approach that only requires meeting the A or A2 designated rating from at least one designated rating organization.

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Concluding Comments

We believe Canadian retail investors have much to gain from the expanded asset classes and strategies being made available in alternative funds space, and commend the CSA for its efforts in advancing these proposals. That said – we remain hopeful that the asset classes and strategies extended are only an *initial first step* – and that the CSA will grant further access to additional commonly used alternative strategies (e.g., real estate) in the near future, to better enable Canadians to meet their investment needs.

We also trust that there will be careful consideration of appropriate proficiency levels for mutual fund dealer salespersons, to ensure that proficiency levels are not needlessly raised to a point that effectively restricts most retail investor access to alternative funds.

We thank you for your consideration of our comments, and welcome your inquiries in English or French, which can be directed to Warren Rudick (at Warren_Rudick@manulife.com or (416) 852-5338) or Anick Morin (at Anick_Morin@manulife.com or (514) 499-7999, ext. 304491).

Yours very truly,

Manulife Asset Management Limited

Bernard Letendre
Director & President, Manulife Investments

CC: Roger Renaud, *Global Chief Operating Officer and President Canada, Manulife Asset Management*

Kai R. Sotorp, *President & Chief Executive Officer, Manulife Asset Management and Manulife Asset Management Limited*

Anick Morin, AVP & Lead Counsel, Investments, *Manulife Investments*

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INCLUDES COMMENT LETTERS

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December 22, 2016

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

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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

INCLUDES COMMENT LETTERS

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December 22, 2016

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 Consumer 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

c/o

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Ladies and Gentlemen,

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

Thank you for the opportunity to comment on the Canadian Securities Administrators' ("**CSA**") Notice and Request for Comment on the Modernization of Investment Fund Product Regulation – Alternative Funds (the "**Proposed Amendments**").

This letter represents the general comments of certain members of the Financial Products & Services practice group at Stikeman Elliott LLP (and not those of the firm generally or any client of the firm) and is submitted without prejudice to any position taken or that may be taken by our firm on its own behalf or on behalf of any client.

While we expect that the consolidation of the rules applicable to publicly offered investment funds in a single instrument will bring added coherence and simplicity to investment fund regulation in Canada, we have concerns with some of the investment restrictions proposed for alternative funds and non-redeemable investment funds and the absence of any grandfathering provisions for existing funds.

We have provided our responses to some of the questions posed by the CSA below followed by commentary on specific aspects of the Proposed Amendments that are not addressed by the questions posed by the CSA.

A. Responses to CSA Questions

Question 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 "non-conventional mutual fund" better reflect these types of funds?

In our view, an alternative fund should be able to select a redemption frequency of its choice (i.e., weekly, monthly, quarterly or no redemptions at all) based on its investment strategy, liquidity features and other investment, operational and market considerations.

In this regard, the CSA should ensure alignment of the NAV calculation requirements and redemption pricing under National Instrument 81-106 *Investment Fund Continuous Disclosure* ("**NI 81-106**"). Section 14.2(3) of NI 81-106 requires investment funds to calculate NAV at least weekly or daily. Sections 9.3 and 10.3 of National Instrument 81-102 *Investment Funds* ("**NI 81-102**") require that investment funds determine the issue price and the redemption price of investment securities at the NAV per security next determined after the receipt of the purchase or redemption order, respectively. These provisions in combination can result in, for example, an investment fund with a monthly redemption date redeeming investors at different NAVs per security per day. We encourage the CSA to remedy this incongruity. Alternative funds that do not have daily redemptions should have the flexibility to specify a redemption pricing date in a manner that is similar to the flexibility granted to exchange-traded mutual funds pursuant to section 10.3(2) of NI 81-102.

We do not believe that the proposed addition of section 10.3(5) provides sufficient flexibility.

Question 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.

Given the variety of potential strategies pursued by alternative funds, we would recommend that the CSA carefully consider whether conventional concentration limits would be appropriate. In particular, the CSA might consider whether timely and appropriate disclosure in the investment strategies and Management Discussion & Analysis of an alternative fund would be desirable instead of imposing a "hard cap" on concentration.

If the CSA imposes a "hard cap", a reasonable period of time should be allowed to facilitate divestment on a basis that would not adversely impact investment returns. The standard for divestment in the case of the illiquid assets restriction, being "as quickly as is commercially reasonable", is a helpful benchmark. In addition, timely exemptive relief from the concentration restriction should be readily available in appropriate circumstances.

Question 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.

We encourage the CSA to use this consultation as an opportunity to consider whether the term "illiquid asset" can be updated to reflect current market realities. NI 81-102 defines "illiquid assets" by reference to whether a portfolio asset can be "readily disposed of through market facilities on which public quotations in common use are widely available at an amount that at least approximates the amount at which the portfolio asset is valued in calculating the net asset value per security of the mutual fund". The definition is difficult to apply in practice because it uses several terms that may be subject to differing interpretations. Furthermore, other factors may be determinative in identifying non-illiquid assets. If the portfolio asset may be disposed of on an arm's length basis outside of a public market and without delay, such portfolio asset should not necessarily be deemed to be an illiquid asset. In this regard, the United States Securities and Exchange Commission's ("**SEC**") approach to defining "illiquid assets" is instructive. Under SEC Rule 22e-4, an "illiquid investment" is defined as:

> any investment that the fund reasonably expects cannot be sold or disposed of in current market conditions in seven calendar days or less without the sale or disposition significantly changing the market value of the investment

The primary advantage of this definition is that it is flexible because it does not rely on the characteristics of the market or the quotation to determine whether it is an illiquid asset. The definition is only tied to whether the fund has a reasonable expectation that the asset can be disposed of within seven days without a significant impact on market value. We submit that the ability to dispose of a security within a period of seven calendar days is also an appropriate interval for mutual funds under NI 81-102, particularly in light of the restrictions on the percentage of illiquid securities can be held by mutual funds. For example, in its September 2014 whitepaper "*ViewPoint* – Fund Structures as Systemic Risk Mitigants", BlackRock Inc. advises that "40 Act Funds are permitted to wire proceeds within seven days after receiving a redemption order. However, funds typically meet redemption requests within a shorter time frame and would not avail themselves to the seven day redemption period other than in extraordinary circumstances."[1] We do not see why the experience in Canada would be different. For this reason, we do not believe that a liquidity test based on a seven-day interval would be inconsistent with the requirement under section 10.4 of NI 81-102 for a mutual fund to pay redemption proceeds within three business days after the relevant date set forth in section 10.4(1)(a) or (b).

We would encourage the CSA to consider adopting an SEC-type definition modified to meet any policy objectives specific to the Canadian market. We expect that a revised definition of "illiquid asset" coupled with Companion Policy guidance and specified exclusions would be easier to apply.

Question 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.

Question 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.

Liquidity requirements are much less relevant for alternative funds and non-redeemable investment funds that have minimal, or no, redemption rights. Accordingly, we encourage the CSA to reconsider its proposal to introduce an investment limit in illiquid assets for all non-redeemable investment funds and for all alternative funds, even where they have limited, or no, redemption features.

The requirement that an investment fund maintain a certain proportion of liquid assets is important where the investment fund has regular and potentially significant cash obligations, such as a daily redemption feature or margin calls by derivative counterparties. Non-redeemable investment funds and alternative funds that have limited, or no, redemption rights are not subject to significant liquidity requirements and should not have a limit on illiquid assets. This view is consistent with the views expressed by the International Organizations for Securities Commissions:

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[1] See https://www.blackrock.com/corporate/en-fi/literature/whitepaper/viewpoint-fund-structures-as-systemic-risk-mitigants-september-2014.pdf.

> The responsible entity should set appropriate liquidity thresholds which are proportionate to the redemption obligations and liabilities of the CIS.
>
> The responsible entity should set appropriate internal definitions and thresholds for the CIS's liquidity, which are in line with the principle of fair treatment of investors and the CIS's investment strategy. The thresholds should act as a signal to the responsible entity to carry out more extensive in-depth, quantitative and/or qualitative liquidity analysis as part of the risk management process (with the intention that the responsible entity would then take appropriate remedial steps if the analysis revealed vulnerabilities).
>
> For example, a daily dealing CIS would be expected to have stricter liquidity requirements than a CIS sold on the basis that investors would not be expected to redeem before a set period expired; or a CIS that invested predominantly in real estate but promised frequent redemption rights to its investors might consider it appropriate to hold a relatively large stock of more liquid assets (which could be related to real estate) as well, because of the expected length of time it would take to dispose of physical properties in order to meet redemption requests.
>
> A responsible entity could place stricter internal thresholds on liquidity than its local regulatory requirements.[2]

Limiting the ability of an investment fund to invest in illiquid assets without accounting for the fund's terms, conditions and policies can result in investors bearing unnecessary costs in the form of reduced returns.

Question 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 should be permitted to borrow from a broader pool of entities than those that meet the definition of a custodian for investment fund assets in Canada (e.g., qualified prime brokers regulated in the U.S., the U.K or other major markets) provided any such entity is subject to prudential supervision or other regulatory oversight in its home country jurisdiction. Access to a deeper and more diversified pool of lenders may help reduce the alternative fund's exposure to a more concentrated pool of qualified lenders and limit associated systemic risks while also assisting alternative funds in obtaining competitive market rates for loans in a foreign-denominated currency. Furthermore, in circumstances where collateral is not physically delivered, a fund bears no counterparty risk as borrower.

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[2] International Organizations for Securities Commissions, Principles of Liquidity Risk Management for Collective Investment Schemes, March 2013, <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD405.pdf>

Question 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 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 endorse the positions reflected in the letter dated December 22, 2016 by the Alternative Investment Management Association. The use of gross notional amount of specified derivatives is not necessarily an appropriate portfolio leverage limit. The SEC described this measure, accurately in our view, as a "relatively blunt measurement".[3] In our view, any leverage definition for specified derivative exposure should include an element of netting of risk-mitigating instruments. Rather than being overly prescriptive, we encourage the CSA to continue the principles-based approach in NI 81-102 and exclude from the exposure limit calculation any exposure associated with derivatives transactions that may be used to hedge or cover other transactions.

Question 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.

Under the Proposed Amendments, non-redeemable investment funds will be one of the few investment funds that cannot transact based on a summary disclosure document once ETF Facts disclosure is implemented in September 2017. The policy reasons for excluding non-redeemable investment funds from point of sale disclosure obligations are unclear given the CSA's objective of harmonizing disclosure regimes.

B. Other Comments on the Proposed Amendments

1. *Grandfathering*

We respectfully submit that existing commodity pools and non-redeemable investment funds should be grandfathered from the investment restrictions in the Proposed Amendments that would be newly applicable. Furthermore, we encourage the CSA to inform the market as soon as possible of any grandfathering that will be permitted and the nature of such grandfathering in the interests of market efficiency. Grandfathered funds should be permitted to conduct their business and operations in compliance with their constating documents and the previously applicable rules.

Securityholders that have invested in non-redeemable investment funds prior to the enactment of the Proposed Amendments should not be forced to decide between either

[3] See "Use of Derivatives by Registered Investment Companies and Business Development Companies," Release No. IC-31933 (Dec. 11, 2015), available at: http://www.sec.gov/rules/proposed/2015/ic-31933.pdf.

maintaining their investment in a materially different investment product or redeeming or otherwise disposing of their interest in the investment product with potentially adverse tax consequences. Furthermore, there may be significant costs to existing funds that are required to change their operations or liquidate a position in their portfolio as a result of newly imposed regulatory requirements. This could have an adverse effect on investors.

2. *Derivatives Terminology and Rehypothecation*

NI 81-102 contains derivatives-related terminology that is vague and inconsistent with established terms used by market participants. We would encourage the CSA to address these concerns as part of this consultation. We adopt the comments made by the International Swaps and Derivatives Association ("**ISDA**") in this regard in its comment letter dated October 17, 2002 regarding Proposed Amendments to NI 81-102 and have attached the comment letter as Schedule "A" hereto for ease of reference.

We also recommend that the guidance on rehypothecation of collateral for OTC derivatives provided by the OSC in the April 2016 edition of the Investment Funds Practitioner be clarified.

3. *Distribution Through Exempt Market Dealers*

We reiterate our remarks in our October 11, 2016 comment letter on Proposed Amendments to National Instrument 31-103 *Registration Requirements, Exemptions and Ongoing Registrant Obligations* ("**NI 31-103**") and its Companion Policy, National Instrument 33-109 *Registration Information* and OSC Rule 33-506 *(Commodity Futures Act) Registration Information* dated July 7, 2016 (the "**EMD Amendments**") and note that, as currently proposed, the EMD Amendments would prohibit the sale by an exempt market dealer of prospectus-qualified mutual fund securities to qualified accredited investors, although the exempt market dealer could continue to sell, to the same class of investors, non-prospectus-qualified pooled funds (which are subject to less regulatory oversight) created for the same strategy. In addition, if the Proposed Amendments are adopted, exempt market dealers which currently offer alternative strategies in a pooled fund format to qualified accredited investors could not offer the same strategy in an NI 81-102-compliant prospectus-qualified format to the same class of investors. Significantly, these additional restrictions would come at a time when the CSA have already implemented robust exempt market reform and CRM2 amendments which exempt market dealers have had to work into their compliance programs in order to continue to service the exempt market for investment fund products.

The exempt market dealer category of registration is critical to the business model of independent manager-manufacturers of conventional mutual funds and would be equally critical to sponsors of NI 81-102-compliant alternative funds. If adopted, the EMD Amendments may deprive these managers of access to the institutional market, access which is vital to the design, development and evolution of new and competing demand-driven asset management solutions in a mutual fund format. Significantly, the dealer registration exemption in section 8.6 (Investment fund trades by adviser to managed account) of NI 31-103, as amended, would not address this gap since advisory arrangements

in the institutional market covering a manager-manufacturer's mutual fund product solutions are commonly entered into on a non-discretionary basis.

4. *Definition of "Designated Rating"*

We note that the credit ratings of major U.S. banks were downgraded in late 2015, among other reasons, on the prospect that the U.S. government would be less likely to provide support to its banking system. External market events such as this one may have the effect of materially reducing the pool of counterparties which meet the prescribed "designated rating" requirements under sections 2.7ff of NI 81-102, with the result that established ISDA arrangements have to be abruptly renegotiated with new counterparties and that NI 81-102-governed investment funds as a whole become exposed to a more concentrated pool of acceptable counterparties (e.g., Canadian banks only). We would recommend that the CSA consider articulating certain limited exceptions to the "designated rating" requirements in circumstances, such as this, where there is an industry-wide, rather than an institution-specific, ratings downgrade that may broadly disrupt a manager's existing counterparty arrangements because of the technical constraints of this definition.

* * *

We thank the Canadian Securities Administrators for the opportunity to comment on the Proposed Amendments and we would be pleased to discuss these issues further.

"Junaid Subhan"

Junaid Subhan
on my own behalf and on behalf of

Alix d'Anglejan-Chatillon
Jeffrey Elliott
Darin R. Renton
William Scott
Ramandeep Grewal
Nick Badeen

SCHEDULE "A"

ISDA COMMENT LETTER RE: PROPOSED AMENDMENTS TO NI 81-102

ISDA

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October 17, 2002

By fax and email

Denise Brosseau, Secretary
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Dear Sirs/Mesdames:

Re: Proposed Amendments to National Instrument 81-102

The purpose of this letter is to comment on the proposed amendment to National Instrument 81-102 Mutual Funds and, in particular, on those aspects of NI 81-102 relating to swaps. The Canadian members of ISDA that are counterparties to transactions with mutual funds believe that the proposed amendments, while helpful, do not sufficiently correct or clarify the existing deficiencies in NI 81-102. It will remain difficult for mutual funds to satisfy themselves that they comply with the instrument and, therefore, that they are able to enter into swaps.

Canadian ISDA members would welcome an opportunity to assist in providing drafting suggestions or information about the swaps market that may assist you in

clarifying the language. While we hope it would be possible to accomplish the required changes in this round of amendments, we appreciate that it may not be and we would strongly encourage you to continue to evolve this instrument in terms of its application to swaps.

ISDA wishes to emphasize that it is not commenting on the basic principle of the instrument, i.e., that mutual funds should not use derivatives to provide leverage. The comments in this letter repeat many of the comments made in our letter to the Ontario Securities Commission dated July 24, 2000.

Section 2.8(1)(f)

Our focus is on section 2.8(1)(f), which is the section with respect to entering into or maintaining a swap position for purposes other than hedging.[1] The fund cannot enter into or maintain a swap unless certain coverage exists for its "long position" and its "short position". Our general comment is that these provisions employ concepts relevant to options that are not relevant to the swaps market and they are, consequently, difficult to understand and apply in that context. Our specific comments are as follows:

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[1] 2.8(1) A mutual fund shall not
(f) enter into, or maintain, a swap position unless
(i) for periods when the mutual fund would be entitled to receive payments under the swap, the mutual fund holds cash cover in an amount that, together with margin on account for the swap and the market value of the swap, is not less than, on a daily mark-to-market basis, the underlying market exposure of the swap; and
(ii) for periods when the mutual fund would be required to make payments under the swap, the mutual fund holds
(A) an equivalent quantity of the underlying interest of the swap,
(B) a right or obligation to acquire an equivalent quantity of the underlying interest of the swap and cash cover that, together with margin on account for the position, is not less than the aggregate amount of the obligations of the mutual fund under the swap, or
(C) a combination of the positions referred to in clauses (A) and (B) that is sufficient, without recourse to other assets of the mutual fund, to enable the mutual fund to satisfy its obligations under the swap.

"margin on account"

With respect to its long position (i.e. it obligation to receive delivery of the underlying interest - in the case of a physically settled swap presumably - or cash) the aggregate of the following three things must at least equal the underlying market exposure of the swap:

- cash cover held by the fund
- margin on account for the swap
- the market value of the long position of the swap

Is the reference to margin on account for the swap a reference to the collateral or margin that the mutual fund has delivered to the counterparty or is it a reference to collateral or margin which the counterparty has delivered to the mutual fund? Presumably the latter, but this should be clarified because we believe that in other parts of the section the same phrase is used to refer to margin provided by the mutual fund.

Also, what is meant by "margin"? In the derivatives area, there are very popular alternative means of collateralizing transactions that do not involve taking a security interest in the property delivered. It would be helpful to have a definition of "margin". In particular, it would be beneficial to have a definition that contemplates collateralization that is not in the form of a security interest. We would be happy to provide information as to what alternative forms of credit support are being used in the market.

Further, typically credit support is provided on a net basis, so that if the mutual fund has several transactions in place with a counterparty, some of which are in-the-money and some of which are out-of-the-money, the collateral is posted for the net exposure and covers all transactions. Presumably the removal of the word "particular" from the existing instrument is intended to permit the mutual fund to consider credit

support provided on such a basis as being "margin on account" for the swap. However, on what basis is the mutual fund to allocate the margin when it is provided on the basis of the net exposures under a group of swaps?

"market value of the long position of the swap"

There is no definition of "market value of the long position of a swap" in NI 81-102. In 13.5(3)[2] it states that the "value" of a swap is the gain or loss on the contract that would be realized if, on the date that valuation is made, the position in the swap were to be closed out. This is a calculation that nets the "short" and "long" positions. Presumably, this concept is not the one that is to be used in determining the market value of the "long position" of the swap. But, if not what is the market value?

Distinguishing between market value and underlying exposure makes sense in the context of options, but in the swaps context market value (if there is one) is really the same concept as exposure.

"underlying market exposure of the swap"

As noted above, the cash cover, the margin on account and the market value of the swap have to be at least equal to the "underlying market exposure of the swap", calculated on a daily mark-to-market basis.

"Underlying market exposure"[3] with respect to a swap means "the underlying market exposure, as calculated under paragraph (b) [of the definition of underlying

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[2] **Valuation of Specified Derivatives** – A mutual fund shall value specified derivatives transactions and positions in accordance with the following principles:

...

3. The value of a forward contract or swap shall be the gain or loss on the contract that would be realized if, on the date that valuation is made, the position in the forward contract or swap were to be closed out.

[3] Means, for a position of a mutual fund in

(a) an option, the quantity of the underlying interest of the option position multiplied by the market value of one unit of the underlying interest, multiplied, in turn, by the delta of the option,

(b) a standardized future or forward contract, the quantity of the underlying interest of the position multiplied by the current market value of one unit of the underlying interest; or

(c) a swap, the underlying market exposure, as calculated under paragraph (b), for the long position of the mutual fund in the swap.

market exposure] for the long position of the mutual fund in the swap." The underlying market exposure under paragraph (b) is the "quantity of the underlying interest of the position multiplied by the current market value of one unit of the underlying interest". "Long position"[4] for a swap means a position held by a mutual fund that "obliges the mutual fund to accept delivery of the underlying interest or receive cash".

Starting with the definition of "long position", it is not clear when a mutual fund would have an obligation to accept delivery of the underlying interest or receive cash. Almost every cash settled swap can be said to require the mutual fund to receive cash at some point. Whether the fund will or will not actually receive cash will depend upon how the market is positioned on the payment dates and the maturity date. In the interim periods there is no obligation to receive cash or anything else. If this calculation is to be made on a "daily" basis, then what is the long position supposed to be?

It is also not clear what the "quantity of the underlying interest of the position" would be. If the swap is, for example, an interest rate swap, so that the underlying interest is an interest rate (e.g. 7%), then what is the "quantity" of the interest rate supposed to refer to? The parties do not deliver a rate. Also, what is the current market value of one unit of a rate of 7%? Take an equity index swap as another example. The underlying interest is the level of the index. Again, the concept of a "quantity" for such an intangible is unclear, as is the concept of such an index having a market value. Mutual funds can in theory make calculations that effectively convert into monetary terms their positions in such intangible underlying interests as rates. (Many rely on the counterparty to make that calculation for them where they are unable to do it themselves, which is often the case.) However, this is simply the mark to market value of the transaction. If this is what is intended, then it is not clear that the language used makes it clear that this is what the mutual fund is required to do.

[4] Means a position held by a mutual fund that, for
(e) a swap, obliges the mutual fund to accept delivery of the underlying interest or receive cash;

Is the instrument trying to say that when the mutual fund is in-the-money, it must calculate its exposure to its counterparty (as opposed to the counterparty's exposure to the mutual fund) on a daily basis? If so, is this not the same thing as saying that the mutual fund should calculate what its gain would be, if any, if the swap was terminated on the day the calculation was made? How does this concept differ from the "market value of the long position of the swap"? If it doesn't differ from the concept of market value of the long position of the swap, then wouldn't market value of the long position of the swap and underlying market exposure always be equal, rendering the formula meaningless? Since we assume that this was not what was intended, we are very unclear as to what underlying market exposure is supposed to measure.

"an equivalent quantity of the underlying interest of the swap"

With respect to its "short position" (i.e. the fund's own delivery obligation), the mutual fund must hold a combination of the underlying interest , a right to acquire the underlying interest and cash cover. In part (a) the instrument refers to "an equivalent quantity of the underlying interest of the short position of the swap". Many underlying interests are not things that can be held. If the underlying interest is an equity index, for example, the mutual fund cannot "hold" the index.

"a right or obligation to acquire an equivalent quantity of the underlying interest of the short position of the swap"

Also, as above, the underlying interests may not be things that can be acquired. The mutual fund may, however, have a right under another swap to receive payments based on the value of that index. Presumably, the mutual fund should be able to take that position into consideration as cover. The section, however, does not appear to allow this as it is not an acquisition of the underlying interest.

"margin on account for the position"

Again, is the reference to margin on account a reference to the collateral or margin that the mutual fund has delivered to the counterparty or is it a reference to collateral or margin that the counterparty has delivered to the mutual fund? Presumably, in this case it is margin that the counterparty holds for the obligations of the mutual fund.

"aggregate amount of the obligations of the mutual fund under the short position of the swap"

The cash cover, the margin on account and the right or obligation to acquire an equivalent quantity of the underlying interest must not be less than the "aggregate amount of the obligations of the mutual fund under the short position of the swap".

Until a payment period or maturity arrives, it may not be clear whether or not the mutual fund has any obligation or what the extent of it is. For example, if the mutual fund is making a payment based on the value of an index, it will not know what the value of the index is and, therefore, what the obligation is until the payment date arrives and even then it may only have to pay the difference between the index and some other variable, such as prime rate. How is the mutual fund supposed to aggregate amounts when it does not know what those amounts are or will be?

Section 2.7(4)[5]

This section provides that the "mark-to-market value of the exposure" of a mutual fund under its specified derivatives with any one counterparty cannot be more than 10% of the net assets of the fund for a period of 30 days or more.

We believe that this should be the mark-to-market value to the mutual fund of its specified derivatives, not the mark-to-market value of the exposure. The mark-to-market value *is* the exposure.

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[5] The mark-to-market value of the exposure of a mutual fund under its specified derivatives positions with any one counterparty other than an acceptable clearing corporation or a clearing corporation that clears and settles transactions made on a futures exchange listed in Appendix A, calculated in accordance with subsection (5), shall not exceed, for a period of 30 days or more, 10 percent of the net assets of the mutual fund.

In addition, the calculation of the mark-to-market value of the exposure of a mutual fund to a counterparty should be net of credit support provided by the counterparty.

Section 2.7(5)[6]

It is not clear how part (b) differs from part (a). The "aggregated" mark-to-market value" of the transactions appear to us to be the same as the "net" mark-to-market values.

Section 6.8(3)[7]

This provision states that a mutual fund may deposit with its counterparty portfolio assets over which it has granted a security interest in connection with a particular specified derivatives transaction.

We are assuming that the grant of a security interest in securities in connection with the mutual fund's net position with respect to a number of specified derivatives transactions would also be permitted. It would perhaps be clearer if this read "in connection with particular specified derivatives transactions".

Also, query whether the word "deposit" is accurate. If the credit support is in the form of securities trading through CDS, for example, the mutual fund does not deposit them with the counterparty, but simply arranges for them to be transferred to the counterparty's account or the counterparty's broker's account at CDS. The words "transfer to" would be preferable.

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[6] The mark-to-market value of specified derivatives positions of a mutual fund with any one counterparty shall be, for the purposes of subsection (4),

(a) if the mutual fund has an agreement with the counterparty that provides for netting or the right of set-off, the net mark-to-market value of the specified derivatives positions of the mutual fund; and

(b) in all other cases, the aggregated mark-to-market value of the specified derivative positions of the mutual fund.

[7] A mutual fund may deposit with its counterparty portfolio assets over which it has granted a security interest in connection with a particular specified derivatives transaction.

Further, it is not clear that this would permit a counterparty to transfer cash collateral for derivatives transactions. The transfer of the cash gives rise to a debtor/creditor relationship between the counterparty and the mutual fund. This obligation can then be set-off against the mutual fund's obligations under the derivatives transactions. The section should specifically provide that the mutual fund may transfer cash to its counterparty which it is providing as credit support in connection with particular specified derivatives transactions.

As noted above, parties often provide credit support by entering into alternative forms of credit arrangement that do not involve security interests. We would recommend that this provision be drafted with these alternative forms in mind.

Section 6.8(4)[8]

Where a person holds margin or collateral from a mutual fund, whether as counterparty or custodian, section 6.8(4) requires the records of the custodian or counterparty to show that the mutual fund is the beneficial owner of the portfolio assets.

How does this apply to cash collateral? The concept of ownership does not apply to cash collateral because it creates a debtor/creditor relationship. The records of the counterparty should show this amount as a receivable owing to the mutual fund. This would be consistent with 13.5(5)(a).

Also, with respect to securities collateral it should be made clear that the counterparty or custodian can hold the securities as part of a fungible bulk and through a clearing agency, such that it is clear that the portfolio assets that the counterparty or custodian is showing that the mutual fund "owns" are not necessarily the same securities as those delivered by the mutual fund. The use of the term "portfolio assets"

[8] The agreement by which portfolio assets of a mutual fund are deposited in accordance with this section shall require the person or company holding portfolio assets of the mutual fund so deposited to ensure that its records show that mutual fund is the beneficial owner of the portfolio assets.

creates some uncertainty in this respect. Also, the phrase "holding portfolio assets of the mutual fund so deposited" would be appropriately changed to "to whom the portfolio assets have been transferred".

As drafted section 6.8(4) would also preclude certain forms of alternative credit support arrangements, as mentioned above.

Section 1.1

"equivalent debt"

Section 2.7(1)(b) requires the "equivalent debt" of the counterparty to have an approved credit rating. "Equivalent debt" means an evidence of indebtedness of approximately the same term as, or a longer term than, the remaining term to maturity of the swap. In some cases the term to maturity of the swap is not an accurate determination of whether it is a short or long term obligation. We suggest that the sections simply refer to the approved credit rating of the person with respect to its debt obligations that are most closely aligned economically with the swap.

Yours truly,

Francois Bourassa
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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]

II

(Non-legislative acts)

REGULATIONS

COMMISSION DELEGATED REGULATION (EU) No 231/2013

of 19 December 2012

supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision

(Text with EEA relevance)

THE EUROPEAN COMMISSION,

Having regard to the Treaty on the Functioning of the European Union,

Having regard to Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010 [1], and in particular Article 3(6), Article 4(3), Article 9(9), Article 12(3), Article 14(4), Article 15(5), Article 16(3), Article 17, Article 18(2), Article 19(11), Article 20(7), Article 21(17), Article 22(4), Article 23(6), Article 24(6), Article 25(9), Article 34(2), Article 35(11), Article 36(3), Article 37(15), Article 40(11), Article 42(3) and Article 53(3) thereof,

Having regard to the opinion of the European Central Bank,

Whereas:

(1) Directive 2011/61/EU empowers the Commission to adopt delegated acts specifying, in particular, the rules relating to calculation of the threshold, leverage, operating conditions for Alternative Investment Fund Managers (hereinafter 'AIFMs'), including risk and liquidity management, valuation and delegation, requirements detailing the functions and duties of depositaries of Alternative Investment Funds (hereinafter 'AIFs'), rules on transparency and specific requirements relating to third countries. It is important that all these supplementing rules begin to apply at the same time as Directive 2011/61/EU so that the new requirements imposed on AIFMs can be effectively put into operation. The provisions in this Regulation are closely interrelated, since they deal with the authorisation, ongoing operation and transparency of AIFMs which manage and, as the case may be, or market AIFs in the Union, which are inextricably linked aspects inherent to the taking up and pursuit of the asset management business. To ensure coherence between those provisions, which should enter into force at the same time, and to facilitate a comprehensive view and compact access to them by persons subject to those obligations, including investors that are non-Union residents, it is desirable to include all delegated acts required by Directive 2011/61/EU in a single Regulation.

(2) It is important to ensure that the objectives of Directive 2011/61/EU are achieved uniformly throughout the Member States, to enhance the integrity of the internal market and offer legal certainty for its participants, including institutional investors, competent authorities and other stakeholders, by adopting a Regulation. The form of a Regulation ensures a coherent framework for all market operators and is the best possible guarantee for a level playing field, uniform conditions of competition and the common appropriate standard of investor protection. Furthermore it ensures the direct applicability of detailed uniform rules concerning the operation of AIFMs, which by their nature are directly applicable and therefore require no further transposition at national level. The recourse to a regulation allows, in addition, to avoid a delayed application of Directive 2011/61/EU in the Member States.

(3) As the Delegated Regulation specifies the tasks and responsibilities of the 'governing body' and of the 'senior management' it is important to clarify the meaning of these terms, in particular the fact that a governing body may be comprised of senior managers. Furthermore, as this Regulation introduces also the term 'supervisory function' the definition of the governing body should make clear that it is the body which comprises the managerial function in case the supervisory and the managerial functions are separated in

[1] OJ L 174, 1.7.2011, p. 1.

accordance with national company law. Directive 2011/61/EU requires AIFMs to provide certain information to competent authorities, including the percentage of the AIF's assets which are subject to special arrangements arising from their illiquid nature. This Regulation clarifies the meaning of special arrangements so that AIFMs know exactly what information they should provide to competent authorities.

(4) Directive 2011/61/EU provides for a lighter regime applicable to those AIFMs who manage portfolios of AIFs whose total assets under management do not exceed the relevant thresholds. It is necessary to specify clearly how the total value of assets under management should be calculated. In this context it is essential to define the steps necessary for calculating the total value of assets, to determine clearly which assets are not included in the calculation, to clarify how the assets acquired through the use of leverage should be valued and to provide rules for handling of cases of cross-holding among AIFs managed by an AIFM.

(5) The total value of assets under management needs to be calculated at least annually and using up-to-date information. The value of assets should therefore be determined in the 12 months preceding the date of calculation of the total value of assets under management and as close as possible to such a date.

(6) To ensure that an AIFM remains eligible to benefit from the lighter regime provided for in Directive 2011/61/EU, it should put in place a procedure making it possible to observe on an ongoing basis the total value of assets under management. The AIFM may consider the types of AIFs under management and the different classes of assets invested in order to assess the likelihood of breaching the threshold or the need for an additional calculation.

(7) Where an AIFM no longer meets the conditions related to the thresholds it should notify its competent authority and apply for an authorisation within 30 calendar days. However, where exceeding or falling below the thresholds occurs only occasionally within a given calendar year and such situations are considered as temporary the AIFM should not be obliged to make an application for authorisation. In those cases, the AIFM should inform the competent authority of the breach of the threshold, and explain why it considers such breach to be of a temporary nature. A situation lasting for more than three months cannot be considered as being temporary. When assessing the likelihood of a situation to be temporary, the AIFM should consider anticipated subscription and redemption activity or, where applicable, capital draw-downs and distribution. The AIFM should not use anticipated market movements as part of this assessment.

(8) Data used by AIFMs to calculate the total value of assets under management do not need to be available to the public or to investors. However, competent authorities must be able to verify that the AIFM is correctly calculating and monitoring the total value of assets under management, including the assessment of occasions when the total value of assets under management temporarily exceeds the relevant threshold and should therefore have access to these data on request.

(9) It is important that AIFMs benefiting from the provisions of the lighter regime in Directive 2011/61/EU provide the competent authorities with up-to-date information at the time of registration. Not all types of AIFMs may have updated offering documents reflecting the latest developments related to the AIFs they manage and such AIFMs may find it more practical to specify the required information in a separate document describing the funds' investment strategy. This could be the case of private equity or venture capital funds which often raise money through negotiations with potential investors.

(10) An AIF which holds only equity shares in listed companies should not be regarded as being leveraged as long as the equity shares are not acquired through borrowing. Where the same AIF purchases options on an equity index, it should be regarded as being leveraged, since it has increased the exposure of the AIF to a given investment.

(11) In order to ensure a uniform application of AIFM obligations to grant an objective overview of the leverage used, it is necessary to provide two methods to calculate the leverage. As it results from market studies, the best results can be achieved by combining the so-called 'gross' and 'commitment' methods.

(12) In order to receive appropriate information for monitoring systemic risks and to gain a complete picture of the use of leverage by the AIFM, information about the exposure of an AIF should be provided to competent authorities and investors both on a gross and on a commitment method basis and all AIFMs should therefore calculate exposure using both the gross and the commitment method. The gross method gives the overall exposure of the AIF whereas the commitment method gives insight in the hedging and netting techniques used by the manager; therefore both methods shall be seen in conjunction. Specifically, the degree to which overall exposure differs between the gross method and the commitment method may provide useful information. If necessary to ensure that any increase of the exposure of AIFs is adequately reflected the Commission may adopt additional delegated acts on an additional and optional method for the calculation of leverage.

(13) When calculating the exposure, all positions of the AIF should initially be included, including short and long assets and liabilities, borrowings, derivative instruments and any other method increasing the exposure where the risks and rewards of assets or liabilities are with the AIF, and all other positions that make up the net asset value.

(14) Borrowing arrangements entered into by the AIF should be excluded if they are temporary in nature and relate to and are fully covered by capital commitments from investors. Revolving credit facilities should not be considered being temporary in nature.

(15) In addition to calculating exposure using the gross method, all AIFMs should calculate exposure using the commitment method. According to the commitment method financial derivative instruments should be converted into equivalent positions in the underlying asset. However, if an AIF invests in certain derivatives in order to off-set the market risk of other assets in which the AIF is invested, under certain conditions, those derivatives should not be converted into an equivalent position in the underlying assets as the exposures of the two investments balance one another. That should be the case where, for instance, an AIF portfolio invests in a certain index and holds a derivative instrument which swaps the performance of that index with the performance of a different index, that should be equivalent to holding exposure to the second index in the portfolio and therefore the AIF's net asset value would not depend on the performance of the first index.

(16) When calculating exposure according to the commitment method, derivatives which fulfil the criteria set out in this Regulation do not provide any incremental exposure. Thus, if the AIF invests in index future contracts and holds a cash position equal to the total underlying market value of future contracts, this would be equivalent to directly investing in index shares and therefore the index future contract should not be taken into account for the purpose of calculating the exposure of the AIF.

(17) When calculating exposure according to the commitment method, AIFMs should be allowed to consider hedging and netting arrangements provided they fulfil the criteria relating to the commitment method.

(18) The requirement that netting arrangements refer to the same underlying asset should be interpreted strictly so that assets which the AIFM considers as equivalent or highly correlated, such as different share classes or bonds issued by the same issuer, should not be considered as identical for the purposes of netting arrangements. The definition of netting arrangements aims to ensure that only those trades which offset the risks linked to other trades, leaving no material residual risk, are taken into account. Combinations of trades which aim to generate a return, however small, by reducing some risks while keeping others should not be considered as netting arrangements, as with arbitrage investment strategies which aim to generate a return by taking advantage of pricing discrepancies between derivative instruments with the same underlying but different maturities.

(19) A portfolio management practice which aims to reduce the duration risk by combining an investment in a long-dated bond with an interest rate swap or to reduce the duration of an AIF bond portfolio by concluding a short position on bond future contracts representative of the interest rate risk of the portfolio (duration hedging) should be considered as a hedging arrangement provided that it complies with the hedging criteria.

(20) A portfolio management practice, which aims to offset the significant risks linked to an investment in a well diversified portfolio of shares by taking a short position on a stock market index future, where the composition of the equity portfolio is very close to that of the stock market index and its return highly correlated to that of the stock market index and where the short position on the stock market index future allows an unquestionable reduction of the general market risk related to the equity portfolio and the specific risk is insignificant, such as a beta-hedging of a well-diversified equity portfolio where the specific risk is considered to be insignificant, should be considered as complying with the hedging criteria.

(21) A portfolio management practice which aims to offset the risk linked to an investment in a fixed interest rate bond by combining a long position on a credit default swap and an interest rate swap which swaps that fixed interest rate with an interest rate equal to an appropriate money market reference rate plus a spread should be considered as a hedging arrangement where all the hedging criteria of the commitment method are in principle complied with.

(22) A portfolio management practice which aims to offset the risk of a given share by taking a short position through a derivative contract on a share that is different to but strongly correlated with that first share should not be considered as complying with the hedging criteria. Although such a strategy relies on taking opposite positions on the same asset class, it does not hedge the specific risk linked to the investment in a certain share. Therefore, it should not be considered as a hedging arrangement as laid down in the criteria related to the commitment method.

(23) A portfolio management practice which aims to keep the alpha of a basket of shares (comprising a limited number of shares) by combining the investment in that basket of shares with a beta-adjusted short position on a future on a stock market index should not be considered as complying with the hedging criteria. Such a strategy

does not aim to offset the significant risks linked to the investment in that basket of shares but to offset the beta (market risk) of that investment and keep the alpha. The alpha component of the basket of shares may dominate over the beta component and as such lead to losses at the level of the AIF. For that reason, it should not be considered as a hedging arrangement.

(24) A merger arbitrage strategy is a strategy that combines a short position on a stock with a long position on another stock. Such a strategy aims to hedge the beta (market risk) of the positions and generate a return linked to the relative performance of both stocks. Similarly, the alpha component of the basket of shares may dominate over the beta component and as such lead to losses at the level of the AIF. It should not be considered as a hedging arrangement as laid down in the criteria related to the commitment method.

(25) A strategy, which aims to hedge a long position in a stock or bond with purchased credit protection on the same issuer, relates to two different asset classes and therefore should not be considered as a hedging arrangement.

(26) When using methods which increase the exposure of an AIF, the AIFM should observe general principles such as considering the substance of the transaction in addition to its legal form. Specifically with respect to repurchase transactions, the AIFM should consider whether the risks and rewards of the assets involved are passed or retained by the AIF. The AIFM should also look through derivative instruments or other contractual arrangements to the underlying assets to determine the possible future commitments of the AIF resulting from those transactions.

(27) As the commitment method leads to interest rates with different maturities being considered as different underlying assets, AIFs that according to their core investment policy primarily invest in interest rate derivatives may use specific duration netting rules in order to take into account the correlation between the maturity segments of the interest rate curve. When setting out its investment policy and risk profile, an AIF should be able to define the level of the interest rate risk and consequently to determine its target duration. The AIF should take into account the predefined target duration when making its investment choices. When the portfolio duration diverges from the target duration, the strategy should not be considered as a duration netting arrangement as laid down in the criteria related to the commitment method.

(28) The duration netting rules allow long positions to be netted with short positions whose underlying assets are different interest rates. The maturities serving as the thresholds of the maturity ranges are two years, seven years and 15 years. Within each maturity range, netting positions should be allowed.

(29) Netting positions between two different maturity ranges should be partially allowed. Penalties have to be applied to the netted positions to allow only partial netting. They should be expressed by means of percentages relying on the average correlations between the maturity ranges for two years, five years, 10 years and 30 years of the interest rate curve. The longer the difference between the maturities of the positions, the more their netting must be subject to a penalty, and therefore the percentages must increase.

(30) Positions whose modified duration is much longer than the whole portfolio's modified duration are not in line with the investment strategy of the AIF and fully matching them should not be allowed. Thus, it should not be acceptable to match an 18 months maturity short position (set in maturity range 1) with a 10 years maturity long position (set in maturity range 3), if the target duration of the AIF is around two years.

(31) When calculating the exposure, AIFs can firstly identify the hedging arrangements. The derivatives involved in these arrangements are then excluded from the global exposure calculation. AIFs should use an exact calculation in hedging arrangements. AIFs should not use duration netting rules in the hedging calculation. The duration-netting rules may be used to convert the remaining interest rate derivatives into their equivalent underlying asset positions.

(32) Pursuant to Directive 2011/61/EU, an AIFM has to ensure that the potential professional liability risks resulting from its activities are appropriately covered either by way of additional own funds or by way of professional indemnity insurance. Uniform application of this provision requires a common understanding of the potential professional liability risks to be covered. The general specification of the risks arising from an AIFM's professional negligence should determine the features of the relevant risk events and identify the scope of potential professional liability, including damage or loss caused by persons who are directly performing activities for which the AIFM has legal responsibility, such as the AIFM's directors, officers or staff, and persons performing activities under a delegation arrangement with the AIFM. In line with the provisions of Directive 2011/61/EU, the liability of the AIFM should not be affected by delegation or sub-delegation and the AIFM should provide adequate coverage for professional risks related to such third parties for whom it is legally liable.

(33) To ensure a common understanding of the general specification, a list of examples should serve as benchmark for identifying potential professional liability risk events. That list should include a wide range of events resulting from negligent actions, errors or omissions, such as the loss of documents evidencing title to investments, misrepresentations, or breach of the various obligations or duties incumbent on the AIFM. It should also include the failure to prevent, by means of adequate internal control systems, fraudulent behaviour within the AIFM's organisation. Damage resulting from failure to carry out sufficient due diligence on an investment that turned out to be fraudulent would trigger the AIFM's liability for professional liability and should be appropriately covered. However, losses incurred because an investment has lost value as a result of adverse market conditions should not be covered. The list should also include valuations that are improperly carried out, which should be understood as a valuation failure breaching Article 19 of Directive 2011/61/EU and the corresponding delegated acts.

(34) In line with their risk management obligations, AIFMs should have appropriate qualitative internal control mechanisms to avoid or mitigate operational failures, including professional liability risks. Therefore, an AIFM should have, as part of its risk management policy, adequate policies and procedures for operational risk management, appropriate to the nature, scale and complexity of its business. Such procedures and policies should in any event enable an internal loss database to be built up to serve for the purpose of assessing the operational risk profile.

(35) To ensure that additional own funds and professional liability insurance appropriately cover potential professional liability risks, quantitative minimum benchmarks should be established for determining the proper level of coverage. Such quantitative benchmarks should be determined by the AIFM as a specific percentage of the value of portfolios of AIFs managed, calculated as the sum of the absolute value of all assets of all AIFs managed, irrespective of whether they are acquired through use of leverage or with investors' money. In this context, derivative instruments should be valued at their market price as they could be replaced at that price. As coverage through professional indemnity insurance is by nature more uncertain than coverage provided through additional own funds, different percentages should apply to the two different instruments used for covering professional liability risk.

(36) To ensure that professional indemnity insurance is effective in covering losses that result from insured events, it should be taken out from an insurance undertaking which is authorised to provide professional indemnity insurance. This includes EU insurance undertakings and non-EU undertakings to the extent that they are permitted to provide such insurance service by Union law or by national law.

(37) In order to allow some flexibility when devising appropriate professional indemnity insurance, it should be possible for the AIFM and the insurance undertaking to agree on a clause providing that a defined amount will be borne by the AIFM as the first part of any loss (defined excess). Where such a defined excess is agreed, the AIFM should provide own funds corresponding to the defined amount of loss to be borne by the AIFM. Such own funds should be in addition to the initial capital of the AIFM and to the own funds to be provided by the AIFM pursuant to Article 9(3) of Directive 2011/61/EU.

(38) As a matter of principle, the adequacy of coverage through additional own funds or professional indemnity insurance should be reviewed at least once a year. However, the AIFM should have procedures in place that ensure ongoing monitoring of the total value of AIF portfolios managed and ongoing adjustments to the amount of coverage of professional liability risks should there be significant mismatches identified. Furthermore, the competent authority of the home Member State of an AIFM may lower or increase the minimum requirement for additional own funds, after taking into account the risk profile of the AIFM, its loss history and the adequacy of its additional own funds or professional indemnity insurance.

(39) Directive 2011/61/EU requires AIFMs to act in the best interests of AIFs, the investors in the AIFs and the integrity of the market. AIFMs should therefore apply appropriate policies and procedures which allow them to prevent malpractices such as market timing or late trading. Market timers take advantage of out of date or stale prices for portfolio securities that impact the calculation of AIF's net asset value (NAV) or buy and redeem

units of the AIF within a few days, thereby exploiting the way the AIF calculates its NAV. Late trading involves placing of orders to buy or redeem units of AIFs after a designated cut off point but the price received is the one of the cut off point. Both malpractices harm the interests of long term investors as they dilute their return and have detrimental effects on AIF's returns as they increase transaction costs and disrupt portfolio management. AIFMs should also establish appropriate procedures to ensure that the AIF is managed efficiently and should act in such a way as to prevent undue costs being charged to the AIF and its investors.

(40) In line with the approach applied to UCITS managers, AIFMs should ensure a high standard of diligence in the selection and monitoring of investments. They should have appropriate professional expertise and knowledge of the assets in which AIFs are invested. In order to ensure that investment decisions are carried out in compliance with the investment strategy and, where applicable, risk limits of the AIFs managed, AIFMs should establish and implement written policies and procedures on due diligence. These policies and procedures should be reviewed and updated on a regular basis. When AIFMs invest in specific types of assets for a long duration, less liquid assets such as real estate or partnership interests, due diligence requirements should apply also to the negotiation phase. The activities performed by the AIFM before closing an agreement should be well documented in order to demonstrate that they are consistent with the economic and financial plan and therefore with the duration of the AIF. AIFMs should maintain minutes of the relevant meetings, the preparatory documentation and the economic and financial analysis conducted for assessing the feasibility of the project and the contractual commitment.

(41) The requirement that AIFMs act with due skill, care and diligence should also apply where the AIFM appoints a prime broker or counterparty. The AIFM should select and appoint only those prime brokers and counterparties, which are subject to ongoing supervision, are financially sound and have the necessary organisational structure appropriate to the services to be provided to the AIFM or the AIF. In order to ensure that investors' interests are adequately protected, it is important to clarify that one of the criteria against which financial soundness should be assessed is whether or not prime brokers or counterparties are subject to relevant prudential regulation, including adequate capital requirements, and effective supervision.

(42) In line with Directive 2011/61/EU, which requires AIFMs to act honestly, fairly and with due skill, persons who effectively direct the business of the AIFM, who are members of the governing body or of the senior management, in the case of entities which do not have a governing body, should possess sufficient knowledge, skills and experience to exercise their tasks, in particular to understand the risks associated with the activity of the AIFM. In line with the Commission's Green Paper on corporate governance in the financial sector [1], persons who effectively direct the business of the AIFM should also commit sufficient time to perform their functions in the AIFM and act with honesty, integrity and independence of mind to, inter alia, effectively assess and challenge the decisions of the senior management.

(43) To ensure that the relevant activities are performed properly, AIFMs should employ personnel with the necessary skills, knowledge and expertise to carry out tasks assigned to them.

(44) AIFMs that provide the service of individual portfolio management have to comply with inducement rules laid down in Commission Directive 2006/73/EC of 10 August 2006 implementing Directive 2004/39/EC of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive [2]. For reasons of consistency, those principles should extend to AIFMs that provide the service of collective portfolio management, and marketing. The existence, nature and amount of the fee, commission or benefit, or, where the amount cannot be ascertained, the method of calculating the amount, should be disclosed in the AIFM's annual report.

(45) Investors in AIFs should benefit from protection similar to that of AIFM clients to whom AIFMs provide the service of individual portfolio management, as in such a case they have to comply with the best execution rules laid down in Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC [3] and Directive 2006/73/EC. However, the differences between the various types of assets in which AIFs are invested should be taken into account, since best execution is not relevant, for instance, when the AIFM invests in real estate or partnership interests and the investment is made after extensive negotiations on the terms of the agreement. Where there is no choice of different execution venues, the AIFM should be able to demonstrate to the competent authorities and auditors that there is no choice of different execution venues.

[1] COM(2010) 284.
[2] OJ L 241, 2.9.2006, p. 26.
[3] OJ L 145, 30.4.2004, p. 1.

(46) For reasons of consistency with requirements applying to UCITS managers, rules on handling of orders and on aggregation and allocation of trading orders should apply to AIFMs when providing collective portfolio management. However, such rules should not apply where the investment in assets is made after extensive negotiations on the terms of the agreement, such as investment in real estate, partnership interests or non-listed companies as in such cases no order is executed.

(47) It is important to specify the situations where conflicting interests are likely to occur, in particular where there is a prospect of financial gain or avoidance of financial loss or where financial or other incentives are provided to steer the behaviour of the AIFM in such a way that it favours particular interests at the expense of interests of other parties, such as another AIF, its clients, undertakings for collective investments in transferable securities (UCITS) or other clients of the AIFM.

(48) The conflicts of interest policy established by the AIFM should identify situations in which activities carried out by the AIFM could constitute conflicts of interest that do or do not lead to potential risks of damage to the AIF's interests or the interests of its investors. To identify them the AIFM should take into account not only the activity of collective portfolio management but also other activities it is authorised to carry out, including activities of its delegates, sub-delegates, external valuer or counterparty.

(49) In line with the approach considered in Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) [1] for UCITS management companies and in Directive 2004/39/EC for investment firms, AIFMs should adopt procedures and measures to ensure that relevant persons engaged in different business activities that could involve conflicts of interest carry out these activities at an independent level, appropriate to the size and activities of the AIFM.

(50) It is essential to provide for a general framework according to which conflicts of interest, if they occur, should be managed and disclosed. The detailed steps and procedures to be followed in such situations should be clarified in the conflicts of interest policy to be established by the AIFM.

(51) One of the central components of a risk management system is a permanent risk management function. In the interest of consistency, its tasks and responsibilities should be similar in nature to those assigned by Commission Directive 2010/43/EU of 1 July 2010 implementing Directive 2009/65/EC of the European Parliament and of the Council as regards organisational requirements, conflicts of interest, conduct of business, risk management and content of the agreement between a depositary and a management company [2] to the permanent risk management function in UCITS management companies. This function should have a primary role in shaping the risk policy of the AIF, risk monitoring and risk measuring in order to ensure that the risk level complies on an ongoing basis with the AIF's risk profile. The permanent risk management function should have the necessary authority, access to all relevant information and regular contacts with the senior management and the governing body of the AIFM in order to provide them with updates so that they can take prompt remedial action where needed.

(52) The risk management policy forms another pillar of the risk management system. That policy should be appropriately documented and should explain, in particular, measures and procedures employed to measure and manage risks, the safeguards for independent performance of the risk management function, the techniques used to manage risks and the details of the allocation of responsibilities within the AIFM for risk management and operating procedures. In order to ensure its effectiveness, the risk management policy should be reviewed at least annually by the senior management.

(53) As required by Directive 2011/61/EU, the function of risk management should be functionally and hierarchically separated from the operating units. It should thus be clarified that such separation should be ensured up to the governing body of the AIFM and that those in the risk management function should not carry out any conflicting tasks or be supervised by someone who is in charge of conflicting functions.

(54) It is essential to specify the safeguards to be employed by the AIFM in any event in order to ensure the independent performance of the risk management function, and in particular, that those performing the risk management function should not be entrusted with conflicting duties, that they should make decisions on the basis of the data which they can appropriately assess and that the decision making process should be capable of being reviewed.

[1] OJ L 302, 17.11.2009, p. 32.

[2] OJ L 176, 10.7.2010, p. 42.

(55) Although Directive 2011/61/EU does not impose any investment restrictions on AIFs, the risks incurred by each AIF cannot be managed effectively if the risk limits have not been set in advance by AIFMs. The risk limits should be in line with the risk profile of the AIF, and should be disclosed to investors in accordance with Directive 2011/61/EU.

(56) For consistency reasons, the requirements relating to identification, measuring and monitoring of risk are built on similar provisions of Directive 2010/43/EU. AIFMs should deal appropriately with the possible vulnerability of their risk measurement techniques and models by carrying out stress tests, back tests and scenario analysis. Where stress tests and scenario analysis reveal particular vulnerability to a given set of circumstances, AIFMs should take prompt steps and corrective actions.

(57) Directive 2011/61/EU requires the Commission to specify the liquidity management systems and procedures enabling the AIFM to monitor the liquidity risk of the AIF, except where the AIF is an un-leveraged closed-ended AIF, and ensure that the liquidity profile of the AIF's investments complies with its underlying obligations. Therefore, it is important to set out fundamental general requirements addressed to all AIFMs, the application of which should be adapted to the size, structure and nature of the AIFs managed by the AIFM concerned.

(58) AIFMs should be able to demonstrate to their competent authorities that appropriate and effective liquidity management policies and procedures are in place. That requires due consideration to be given to the nature of the AIF, including the type of underlying assets and the amount of liquidity risk to which the AIF is exposed, the scale and complexity of the AIF or the complexity of the process to liquidate or sell assets.

(59) Liquidity management systems and procedures can allow AIFMs to apply the tools and arrangements necessary to cope with illiquid assets and related valuation problems in order to respond to redemption requests. Such tools and arrangements may include, where allowed under national law, gates, partial redemptions, temporary borrowings, notice periods and pools of liquid assets. 'Side pockets' and other mechanisms where certain assets of the AIF are subject to similar arrangements between the AIF and its investors should be regarded as 'special arrangements' as they impact the specific redemption rights of investors in the AIF. The suspension of an AIF should not be considered as a special arrangement as this applies to all of the AIF's assets and all of the AIF's investors. The use of tools and special arrangements to manage liquidity should be made dependent on concrete circumstances and should vary according to the nature, scale and investment strategy of the AIF.

(60) The requirement to monitor the liquidity management of underlying collective investment undertakings in which AIFs invest, along with the requirements to put in place tools and arrangements to manage liquidity risk and identify, manage and monitor conflicts of interest between investors should not apply to AIFMs managing AIFs of the closed-ended type regardless of whether they are deemed to be employing leverage. The exemption from those redemption-related liquidity management requirements should reflect the differences in the general redemption terms of investors in a closed-ended AIF compared to those in an open-ended AIF.

(61) The use of minimum limits regarding the liquidity or illiquidity of the AIF could provide an effective monitoring tool for certain types of AIFMs. Exceeding a limit may not of itself require action by the AIFM as this depends on the facts and circumstances and the tolerances set by the AIFM. Limits could thus be used in practice in relation to monitoring average daily redemption versus fund liquidity in terms of days over the same period. That could also be used to monitor investor concentration to support stress testing scenarios. Those limits could provide triggers for continued monitoring or remedial action depending on the circumstances.

(62) The stress tests should, where appropriate, simulate shortage of liquidity of the assets as well as atypical redemption requests. Recent and expected future subscriptions and redemptions should be taken into consideration together with the impact of anticipated AIF performance relative to peers on such activity. The AIFM should analyse the period of time required to meet redemption requests in the stress scenarios simulated. The AIFM should also conduct stress tests on market factors such as foreign exchange movements which could materially impact the credit profile of the AIFM or that of the AIF and as a result collateral requirements. The AIFM should account for valuation sensitivities under stressed conditions in its approach to stress testing or scenario analysis.

(63) The frequency with which stress tests should be conducted should depend on the nature of the AIF, the investment strategy, liquidity profile, type of investor and redemption policy of the AIF. However, it is expected that those tests will be conducted at least on an annual basis. Where stress tests suggest significantly higher than expected liquidity risk, the AIFM should act in the best interest of all AIF investors taking into consideration the liquidity profile of the AIF's assets, the level of redemption requests and where appropriate the adequacy of the liquidity management policies and procedures.

(64) Directive 2011/61/EU requires the Commission to specify how the investment strategy, liquidity profile and redemption policy are to be aligned. The consistency between those three elements is ensured if investors are able to redeem their investments in accordance with the AIF redemption policy, which should cover conditions for redemption in both normal and exceptional circumstances, and in a manner consistent with the fair treatment of investors.

(65) Directive 2011/61/EU requires cross-sectoral consistency and the removal of misalignment between the interests of originators that repackage loans into tradable securities and AIFMs that invest in those securities or other financial instruments on behalf of AIFs. To achieve that aim, the relevant provisions of Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions [1] that lay down the quantitative and qualitative requirements to be met by investors exposed to the credit risk of a securitisation, by originators and by sponsors have been taken into account. As the same objective of aligning the interests of the originator or sponsor and the interests of investors are pursued by this Regulation and the relevant provisions of Directive 2006/48/EC it is essential that the terminology is used consistently in both legal acts, therefore the definitions given in Directive 2006/48/EC are taken as reference. Given that the Committee of European Banking Supervisors, the predecessor of the European Banking Authority, has provided detailed Guidelines for interpreting the relevant provisions of Directive 2006/48/EC [2], achieving cross-sectoral consistency requires the current provisions seeking to align interests between originators, sponsors and AIFMs to be interpreted in light of those Guidelines.

(66) It is important that transactions that re-package loans into tradable securities are not structured in such a way as to avoid the application of the requirements relating to investments in securitisation positions. Therefore, the reference to an investment in tradable securities or other financial instruments based on repackaged loans should not be interpreted strictly as a legally valid and binding transfer of title with respect to such instruments, but as an investment made in a material economic sense so that any other forms of synthetic investments should be covered and subject to the specific requirements. To avoid misunderstandings and align the language with that used in the banking legislation, the terms 'assumption of exposure to the credit risk of a securitisation' should be used instead of 'investment in tradable securities or other financial instruments based on repackaged loans'.

(67) The requirements that need to be met by institutions acting as originators, sponsors or original lenders of a securitisation are directly imposed on them by way of Directive 2006/48/EC. It is therefore important to prescribe the corresponding duties of an AIFM assuming exposure to securitisations. Consequently, the AIFM should assume exposure to securitisations only if the originator, sponsor or original lender has explicitly disclosed to the AIFM the retention of a significant economic interest in the underlying asset, known as retention requirement. Furthermore, the AIFM should ensure that various qualitative requirements imposed on the sponsor and originator through Directive 2006/48/EC are met. In addition, the AIFM should itself meet qualitative requirements in order to have a comprehensive and thorough understanding of the securitisation investment and its underlying exposure. To achieve that, AIFMs should make their investment decision only after having conducted careful due diligence from which they should have adequate information on and knowledge of the securitisations concerned.

(68) There are circumstances in which entities meet the definition of originator or sponsor, or fulfil the role of original lender; however, another entity that neither meets the definition of sponsor or originator, nor fulfils the role of original lender — but whose interests are most optimally aligned with those of investors — may seek to fulfil the retention requirement. For the sake of legal certainty, such other entity should not be required to fulfil the retention requirement if the retention requirement is fulfilled by the originator, sponsor or original lender.

[1] OJ L 177, 30.6.2006, p. 1.

[2] Committee of European Banking Supervisors, Guidelines to Article 122a of the Capital Requirements Directive of 31 December 2010, http://www.eba.europa.eu/cebs/media/Publications/Standards%20and%20Guidelines/2010/Application%20of%20Art.%20122a%20of%20the%20CRD/Guidelines.pdf

(69) In case of a breach of the retention requirement or the qualitative requirements the AIFM should consider taking some corrective action, such as hedging, selling or reducing the exposure or approaching the party in breach of the retention requirement with a view to reinstating compliance. Such corrective action should always be in the interest of the investors and should not involve any direct obligation to sell the assets immediately after the breach has become apparent, therefore avoiding a 'fire sale'. The AIFM should take the breach into account when considering making another investment in a further transaction in which the party in breach of the requirement is involved.

(70) In order to comply with the requirements of Directive 2011/61/EU to specify internal procedures and organisational arrangements, which each AIFM should apply, AIFMs should be required to establish a well-documented organisational structure that clearly assigns responsibilities, defines control mechanisms and ensures a good flow of information between all parties involved. AIFMs should also establish systems to safeguard information and ensure business continuity. When establishing those procedures and structures, AIFMs should take into account the principle of proportionality which allows procedures, mechanisms and organisational structure to be calibrated to the nature, scale and complexity of the AIFM's business and to the nature and range of activities carried out in the course of its business.

(71) Disclosure to investors is of paramount importance to protect those investors, so AIFMs should implement appropriate policies and procedures to ensure that the redemption terms applicable to a particular AIF are disclosed in sufficient detail and with sufficient prominence to investors before they invest and in the event of material changes. That could include disclosure of notice periods in relation to redemptions, details of lock-up periods, an indication of circumstances in which normal redemption mechanisms might not apply or may be suspended, and details of any measures that may be considered by the governing body, such as gates, side pocketing, as they have an impact on the specific redemption rights of investors in the particular AIF.

(72) To ensure that the relevant activities are performed properly, AIFMs, in particular, should use suitable electronic systems in order to fulfil the recording requirements with regard to portfolio transactions or subscription and redemption orders and establish, implement and maintain accounting policies and procedures to ensure that the calculation of the net asset value is carried out as required in Directive 2011/61/EU and this Regulation.

(73) In order to ensure consistency with the requirements imposed on UCITS managers by Directive 2009/65/EC, the governing body, the senior management, or, where relevant the supervisory function of the AIFM should be entrusted with similar types of tasks to which adequate responsibilities should be allocated. However, such allocation of responsibilities should be consistent with the role and responsibilities of the governing body, the senior management and the supervisory function under applicable national law. Senior management may include some or all of the members of the governing body.

(74) The requirement to establish a permanent and effective compliance function should always be fulfilled by the AIFM, irrespective of the size and complexity of its business. However, details of the technical and personnel organisation of the compliance function should be calibrated to the nature, scale and complexity of the AIFM's business and the nature and range of its services and activities. The AIFM should not have to establish an independent compliance unit if such a requirement would be disproportionate in view of the size of the AIFM or the nature, scale and complexity of its business.

(75) Valuation standards differ across jurisdictions and asset classes. This Regulation should supplement the common general rules and establish benchmarks for AIFMs when developing and implementing appropriate and consistent policies and procedures for the proper and independent valuation of the assets of AIFs. The policies and procedures should describe the obligations, roles and responsibilities pertaining to all parties involved in the valuation, including external valuers.

(76) The value of assets can be determined, in different ways, such as by reference to observable prices in an active market or by an estimate using other valuation methodologies according to national law, the AIF rules or its instruments of incorporation. As the value of individual assets and liabilities can be determined by different methodologies and can be taken from different sources, the AIFM should determine and describe the valuation methodologies it uses.

(77) Where a model is used for valuing assets, the valuation procedures and policies should indicate the main features of the model. Before it is used, that model should be subject to a validation process conducted by an internal or external individual who was not involved in the process of building the model. A person should be considered qualified to conduct a validation process in respect of the model used to value assets if he is in possession of adequate competence and experience in the valuation of assets using such models; such person could be an auditor.

(78) Since AIFs operate in a dynamic environment where investment strategies may change over time, valuation policies and procedures should be reviewed at least yearly and in any event before AIFs engage with a new investment strategy or a new type of asset. Any change in the valuation policies and procedures, including the valuation methodologies, should follow a predetermined process.

(79) The AIFM has to ensure that the individual assets of an AIF have been valued properly, in line with the valuation policies and procedures. For some assets, especially complex and illiquid financial instruments, there is a higher risk of inappropriate valuation. To address this type of situation, the AIFM should put in place sufficient controls to ensure that an appropriate degree of objectivity can be attached to the value of the AIF's assets.

(80) Calculation of the net asset value per unit or share is subject to national law and, as the case may be, or the fund rules or instruments of incorporation. This Regulation covers only the procedure for the calculation, and not the methodology of the calculation. The AIFM may itself carry out the calculation of the net asset value per unit or share as part of the administration functions it performs for the AIF. Alternatively, a third party may be appointed to perform administration, including calculation of the net asset value. A third party that carries out the calculation of the net asset value for an AIF should not be considered an external valuer for the purposes of Directive 2011/61/EU, as long as it does not provide valuations for individual assets, including those requiring subjective judgement, but incorporates into the calculation process values which are obtained from the AIFM, pricing sources or an external valuer.

(81) There are valuation procedures that can be performed on a daily basis such as the valuation of financial instruments, but there are also valuation procedures that cannot be carried out with the same frequency as issues, subscriptions, redemptions and cancellations take place, for instance the valuation of real estate. The frequency of valuation of the assets held by an open-ended fund should take into account the differences in the valuation procedures with respect to the types of assets held by the AIF.

(82) The strict requirements and limitations which have to be complied with when an AIFM intends to delegate the task of carrying out functions are set out in Directive 2011/61/EU. The AIFM remains at all times fully responsible for the proper performance of the delegated tasks and their compliance with Directive 2011/61/EU and its implementing measures. The AIFM should therefore ensure that the delegate performs and applies the quality standards which would be applied by the AIFM itself. Also, if necessary to ensure that delegated functions are performed to a consistently high standard, the AIFM has to be able to terminate the delegation and the delegation arrangement should therefore confer flexible termination rights on the AIFM. The delegation limitations and requirements should apply to the management functions set out in Annex I to Directive 2011/61/EU, whereas supporting tasks like administrative or technical functions assisting the management tasks such as logistical support in the form of cleaning, catering and procurement of basic services or products, should not be deemed to constitute delegation of AIFM functions. Other examples of technical or administrative functions are buying standard software 'off-the-shelf' and relying on software providers for ad hoc operational assistance in relation to off-the-shelf systems or providing human resources support such as sourcing of temporary employees or processing of payroll.

(83) To ensure a high level of investor protection in addition to the increase of the efficiency of the conduct of the business of the AIFM the entire delegation should be based on objective reasons. When assessing these reasons, competent authorities should consider the structure of the delegation and its impact on the structure of the AIFM and the interaction of the delegated activities with the activities remaining with the AIFM.

(84) In order to assess whether the person who effectively conducts the business of the delegate is of sufficiently good repute, the person's conduct of business should be verified as well as whether he has committed offences regarding financial activities. Any other relevant information concerning personal qualities which might adversely affect the person's conduct of business such as doubts in relation to his honesty and integrity should be considered when assessing the requirement of sufficient good repute.

(85) Investment companies authorised under Directive 2009/65/EC are not deemed to be undertakings which are authorised or registered for the purposes of asset management and subject to supervision because they are not allowed to engage in activities other than collective portfolio management under that Directive. Similarly, an internally managed AIF should not be deemed to be classified as such an undertaking because it should not engage in activities other than the internal management of the AIF.

(86) Where the delegation concerns portfolio management or risk management, which are the core business of the AIFM and therefore of high relevance with respect to investor protection and systemic risk, in addition to the requirements of Article 20(1)(c) of Directive 2011/61/EU the competent authority of the home Member State of the AIFM and the supervisory authority of the third country undertaking should have concluded a cooperation arrangement based on a written agreement. The arrangement should be in place prior to the delegation. The details of this agreement should take international standards into consideration.

(87) Written arrangements should confer on competent authorities the right to carry out on-site inspections, including where they request the third-country supervisory authority of the undertaking, to which functions were delegated, to carry out on-site inspections and where they request permission from the third-country supervisory authority to carry out the inspection themselves, or to accompany staff of the third-country supervisory authority in order to assist them in carrying out on-site inspections.

(88) Based on the obligations laid down in Directive 2011/61/EU, AIFMs should always act in the best interests of the AIFs or the investors in the AIFs they manage. Therefore, delegation should be admissible only if it does not prevent the AIFM from acting or managing the AIF in the best interests of the investors.

(89) To maintain a high standard of investor protection possible conflicts of interest have to be taken into account for any delegation. Several criteria should set benchmarks for identifying situations which would result in a material conflict of interest. Those criteria should be understood as non-exhaustive and meaning that non-material conflicts of interest are also relevant for the purposes of Directive 2011/61/EU. Thus, the carrying out of compliance or audit functions should be deemed as conflicting with portfolio management tasks, whereas market making or underwriting should be understood as conflicting with portfolio or risk management. That obligation is without prejudice to the obligation of the delegate to separate functionally and hierarchically the tasks of portfolio and risk management from each other according to the provisions of Article 15 of Directive 2011/61/EU.

(90) The requirements applying to the delegation of the task of carrying out functions on behalf of the AIFM should apply *mutatis mutandis* where the delegate sub-delegates any of the functions delegated to it and also in the case of any further sub-delegation.

(91) To ensure that in any event the AIFM performs investment management functions, the AIFM should not delegate its functions to the extent that, in essence, it can no longer be considered to be the manager of the AIF and to the extent that it becomes a letter-box entity. The AIFM should at all times keep sufficient resources to supervise the delegated functions efficiently. The AIFM has to perform itself investment management functions, to have the necessary expertise and resources, to keep the power to take decisions which fall under senior management responsibility and to perform senior management functions, which could include implementation of the general investment policy and investment strategies.

(92) The assessment of a delegation structure is a complex exercise that has to be based on a series of criteria in order for the competent authorities to form their judgement. The combination is necessary to take into account the variety of fund structures and investment strategies across the Union. ESMA may develop guidelines to ensure a consistent assessment of delegation structures across the Union.

(93) The Commission shall monitor how the criteria are applied and their impact on the markets. The Commission shall review the situation after two years and, should it prove necessary, shall take appropriate measures to further specify the conditions under which the AIFM shall be deemed to have delegated its functions to such an extent that it becomes a letter box entity and can no longer be considered to be the manager of the AIF.

(94) Directive 2011/61/EU lays down an extensive set of requirements regarding the depositary of an AIF in order to ensure a high standard of investor protection. The respective concrete rights and obligations of the depositary, the AIFM and, as the case may be, or the AIF and third parties should therefore be set out clearly. The written contract should comprise all details necessary for the appropriate safe-keeping of all the AIF's assets by the depositary or a third party to whom safe-keeping functions are delegated in accordance with Directive 2011/61/EU and for the depositary to properly fulfil its oversight and control functions. In order to allow the depositary to assess and monitor custody risk, the contract should provide sufficient detail on the categories of assets in which the AIF may invest and cover the geographical regions in which the AIF plans to invest. The contract should also contain details of an escalation procedure. Thus, the depositary should alert the AIFM to any material risk identified in a particular market's settlement system. With respect to the termination of the contract, it should reflect the fact that the termination of the contract is the depositary's last resort if it is not satisfied that the assets are sufficiently protected. It should also prevent moral hazard whereby the AIFM would make investment decisions irrespective of custody risks on the basis that the depositary would be liable in most cases. In order to maintain a high standard of investor protection, the requirement laying down the details for the monitoring of third parties should be applied in relation to the whole custody chain.

(95) A depositary established in a third country should be subject to public prudential regulation and to prudential supervision performed by a supervisory authority which is competent for ongoing supervision, undertaking investigations and imposing sanctions. Where that supervision of the depositary involves multiple supervisory authorities, one supervisory authority should act as the contact point for the purposes of Directive 2011/61/EU and all delegated and implementing measures adopted pursuant to it.

(96) The assessment of the law of the third country according to Article 21(6) last subparagraph of Directive 2011/61/EU should be made by the European Commission by comparing the authorisation criteria and the ongoing operating conditions applicable to the depositary in the third country with the corresponding requirements applicable under Union law to credit institutions and, as the case may be, or to investment firms for access to the depositary business and performance of the depositary functions, with a view to ascertaining whether the local criteria have the same effect as those established under Union law. A depositary which is subject to prudential oversight and licensed in the third country under a local category other than a credit institution or an investment firm may be assessed by the European Commission with a view to ascertaining whether the relevant provisions of the law of the third country have the same effect as those established by the law of the Union for credit institutions and, as the case may be, or for investment firms.

(97) In order for the depositary to have a clear overview of all inflows and outflows of cash of the AIF in all instances, the AIFM should ensure that the depositary receives without undue delay accurate information related to all cash flows, including from any third party with which an AIF's cash account is opened.

(98) In order for the AIF's cash flows to be properly monitored the depositary's obligation consists of making sure that there are procedures in place and effectively implemented to appropriately monitor the AIF's cash flows and that these procedures are periodically reviewed. In particular, the depositary should look into the reconciliation procedure to satisfy itself that the procedure is suitable for the AIF and performed at appropriate intervals taking into account the nature, scale and complexity of the AIF. Such a procedure should for example compare one by one each cash flow as reported in the bank account statements with the cash flows recorded in the AIF's accounts. Where reconciliations are performed on a daily basis as for most open-ended AIFs, the depositary should perform its reconciliation also on a daily basis. The depositary should in particular monitor the discrepancies highlighted by the reconciliation procedures and the corrective measures taken in order to notify without undue delay the AIFM of any anomaly which has not been remedied and to conduct a full review of the reconciliation procedures. Such a review should be performed at least once a year. The depositary should also identify on a timely basis significant cash flows and in particular those which could be inconsistent with the AIF's operations, such as changes in positions in AIF's assets or subscriptions and redemptions, and it should receive periodically cash account statements and check the consistency of its own records of cash positions with those of the AIFM. The depositary should keep its record up to date in accordance with Article 21(8)(b) of Directive 2011/61/EU.

(99) The depositary has to ensure that all payments made by or on behalf of investors upon the subscription of shares or units of an AIF have been received and booked in one or more cash accounts in accordance with Directive 2011/61/EU. The AIFM should therefore ensure that the depositary is provided with the relevant information it needs to properly monitor the receipt of investors' payments. The AIFM has to ensure that the depositary obtains this information without undue delay when the third party receives an order to redeem or issue shares or units of an AIF. The information should therefore be transmitted at the close of the business day from the entity which is responsible for the subscription and redemption of shares or units of an AIF to the depositary in order to avoid any misuse of investors' payments.

(100) Depending on the type of assets to be safe-kept, assets are either to be held in custody, as with financial instruments which can be registered in a financial instruments account, or which can be physically delivered to the depositary in accordance with Directive 2011/61/EU, or to be subject to ownership verification and record-keeping. The depositary should hold in custody all financial instruments of the AIF or of the AIFM acting on behalf of the AIF that could be registered or held in an account directly or indirectly in the name of the depositary or a third party to whom custody functions are delegated, notably at the level of the central securities depositary. In addition to these situations those financial instruments are to be held in custody that are only directly registered with the issuer itself or its agent in the name of the depositary or a third party to whom custody functions are delegated. Those financial instruments that in accordance with applicable national law are only registered in the name of the AIF

with the issuer or its agent, such as investments in non-listed companies by private equity and venture capital funds, should not be held in custody. All financial instruments which could be physically delivered to the depositary should be held in custody. Provided that the conditions on which financial instruments are to be held in custody are fulfilled, financial instruments which are provided as collateral to a third party or are provided by a third party for the benefit of the AIF have to be held in custody too by the depositary itself or by a third party to whom custody functions are delegated as long as they are owned by the AIF or the AIFM acting on behalf of the AIF. Also, financial instruments owned by the AIF or by the AIFM on behalf of the AIF, for which the AIF, or the AIFM on behalf of the AIF, has given its consent to re-use by the depositary, remain in custody as long as the right of re-use has not been exercised.

(101) Financial instruments which are held in custody should be subject to due care and protection at all times. To ensure that the custody risk is properly assessed, in exercising due care, the depositary should in particular know which third parties constitute the custody chain, ensure that the due-diligence and segregation obligations have been maintained throughout the whole custody chain, ensure that it has an appropriate right of access to the books and records of third parties to whom custody functions are delegated, ensure compliance with these requirements, document all of these duties and make these documents available to and report to the AIFM.

(102) In order to avoid circumvention of the requirements of Directive 2011/61/EU, the depositary should apply the safe-keeping duties to the underlying assets of financial structures and, as the case may be, or legal structures controlled directly or indirectly by the AIF or by the AIFM acting on behalf of the AIF. That look-through provision should not apply to funds of funds or master-feeder structures provided they have a depositary which safe-keeps the fund's assets appropriately.

(103) The depositary should at all times have a comprehensive overview of all assets that are not financial instruments to be held in custody. Those assets would be subject to the obligation to verify the ownership and maintain a record under Directive 2011/61/EU. Examples of such assets are physical assets which do not qualify as financial instruments under Directive 2011/61/EU or could not be physically delivered to the depositary, financial contracts such as derivatives, cash deposits or investments in privately held companies and interests in partnerships.

(104) To achieve a sufficient degree of certainty that the AIF or the AIFM acting on behalf of the AIF is indeed the owner of the assets, the depositary should make sure it receives all information it deems necessary to be satisfied that the AIF or the AIFM acting on behalf of the AIF holds the ownership right over the asset. That information could be a copy of an official document evidencing that the AIF or the AIFM acting on behalf of the AIF is the owner of the asset or any formal and reliable evidence that the depositary considers appropriate. If necessary, the depositary should request additional evidence from the AIF or the AIFM or as the case may be from a third party.

(105) The depositary should keep a record of all assets for which it is satisfied that the AIF holds ownership. It may set up a procedure to receive information from third parties, whereby procedures which ensure that the assets could not be transferred without the depositary or the third party to whom safe-keeping functions are delegated having been informed of such transactions may be feasible in the case of AIFs with infrequent transactions and, as the case may be, or transactions which are subject to pre-settlement negotiation. The requirement to have access to documentary evidence of each transaction from a third party could be appropriate for AIFs with more frequent portfolio trading, such as investments in listed derivatives.

(106) In order to ensure that the depositary is able to conduct its duties, it is necessary to clarify the tasks provided for in Article 21(9) of Directive 2011/61/EU, and in particular the second layer controls to be undertaken by the depositary. Such tasks should not prevent the depositary from conducting *ex-ante* verifications where it deems appropriate, and in agreement with the AIFM. In order to ensure that it is able to conduct its duties, the depositary should establish its own escalation procedure to address situations where irregularities have been detected. That procedure should ensure the notification of competent authorities of any material breaches. The oversight responsibilities of the depositary towards third parties specified by this Regulation are without prejudice to the responsibilities incumbent on the AIFM under Directive 2011/61/EU.

(107) The depositary should check the consistency between the number of units or shares issued and the subscription proceeds received. Moreover, to ensure that payments made by investors upon subscription have been received, the depositary should further ensure that another reconciliation is conducted between the subscription orders and the subscription proceeds. The same reconciliation should be performed with regard to redemption orders. The depositary should also verify that the number of units or shares in the AIF's accounts matches the number of outstanding units or shares in the AIF's register. The depositary should adapt its procedures accordingly, taking into account the frequency of subscriptions and redemptions.

(108) The depositary should take all necessary steps to ensure that appropriate valuation policies and procedures for the assets of the AIF are effectively implemented, through the performance of sample checks or by comparing the consistency of the change in the NAV calculation over time with that of a benchmark. When setting up its procedures, the depositary should have a clear understanding of the valuation methodologies used by the AIFM or the external valuer to value the AIF's assets. The frequency of such checks should be consistent with the frequency of the AIF's asset valuation.

(109) By virtue of its obligation of oversight under Directive 2011/61/EU, the depositary should set up a procedure to verify on an *ex-post* basis the AIF's compliance with applicable law and regulations and its rules and instruments of incorporation. This covers areas such as checking that the AIF's investments are consistent with its investment strategies as described in the AIF's rules and offering documents and ensuring that the AIF does not breach its investment restrictions, if any. The depositary should monitor the AIF's transactions and investigate any unusual transactions. If the limits or restrictions set out in the applicable national law or regulations or the AIF rules and instruments of incorporation are breached, the depositary should, for example, obtain an instruction from the AIFM to reverse the transaction that was in breach at its own costs. This Regulation does not prevent the depositary from adopting an *ex ante* approach where it deems it appropriate and in agreement with the AIFM.

(110) The depositary should ensure that the income is calculated accurately in accordance with Directive 2011/61/EU. In order to achieve this the depositary has to ensure that the income distribution is appropriate and, where it identifies an error, that the AIFM takes appropriate remedial action. Once the depositary has ensured this, it should verify the completeness and accuracy of the income distribution and in particular of the dividend payments.

(111) When delegating safe-keeping functions related to other assets according to Directive 2011/61/EU, delegation is likely to concern administrative functions in most cases. Where the depositary delegates record-keeping functions, it would therefore be required to implement and apply an appropriate and documented procedure to ensure that the delegate complies with the requirements of Article 21(11)(d) of Directive 2011/61/EU at all times. In order to ensure a sufficient level of protection of assets, it is necessary to set out certain principles that should be applied in relation to the delegation of safekeeping. For the delegation of custody duties it is important to set out some key principles which have to be effectively applied throughout the delegation process. Those principles should not be taken to be exhaustive, either in terms of setting out all details of the depositary's exercise of due skill care and diligence, or in terms of setting out all the steps that a depositary should take in relation to these principles themselves. The obligation to monitor on an ongoing basis the third party, to whom safekeeping functions have been delegated should consist of verifying that this third party correctly performs all the delegated functions and complies with the delegation contract. The third party should act honestly, in good faith with a view to the best interests of the AIF and its investors, in compliance with regulatory and supervisory requirements, and should exercise care, diligence and skill that are normally expected from a highly prudent operator of that financial profession in comparable circumstances. The depositary should review, inter alia, elements assessed during the selection and appointment process and put these elements into perspective by comparing them with the development of the market. The form of the regular review should reflect circumstances, so that the depositary is in a position to appropriately assess the risks related to the decision to entrust assets to the third party. The frequency of the review should be adapted so as to always remain consistent with market conditions and associated risks. For the depositary to effectively respond to a possible insolvency of the third party, it should undertake contingency planning, including the design of alternative strategies and the possible selection of alternative providers as may be relevant. While such measures may reduce the custody risk faced by a depositary, they do not alter the obligation to return the financial instruments or pay the corresponding amount should they be lost, which depends on whether or not the requirements of Article 21(12) of Directive 2011/61/EU are fulfilled.

(112) When delegating safe-keeping functions, the depositary should ensure that the requirements of Article 21(11)(d)(iii) of Directive 2011/61/EU are fulfilled and that the assets of the AIF clients of the depositary are properly segregated. This obligation should particularly ensure that assets of the AIF are not lost due to insolvency of the third party to whom safekeeping functions are delegated. In order to minimise that risk in countries where the effects of segregation are not recognised by insolvency law, the depositary should take further steps. The depositary could make a disclosure to the AIF and the AIFM acting on behalf of the AIF so that such aspects of the custody risk are properly taken into account in the investment decision or take such measures

as are possible in the local jurisdictions to make the assets as insolvency-proof as possible according to local law. Furthermore, the depositary could prohibit temporary deficits in client assets, use buffers or put in place arrangements prohibiting the use of a debit balance for one client to offset a credit balance for another. While such measures may reduce the custody risk faced by a depositary when delegating custody functions, they do not alter the obligation to return the financial instruments or pay the corresponding amount where these are lost, which depends on whether or not the requirements of Directive 2011/61/EU are fulfilled.

(113) The depositary's liability under Article 21(12) second subparagraph of Directive 2011/61/EU is triggered in the event of the loss of a financial instrument held in custody by the depositary itself or by a third party to whom the custody has been delegated, provided that the depositary does not demonstrate that the loss results from an external event beyond reasonable control, the consequences of which would have been unavoidable despite all reasonable efforts to the contrary. That loss should be distinguished from an investment loss for investors resulting from a decrease in the value of assets as a consequence of an investment decision.

(114) To be ascertained as such, it is important that the loss is definitive, and there is no prospect of recovering the financial asset. Thus, situations where a financial instrument is only temporarily unavailable or frozen should not count as losses within the meaning of Article 21(12) of Directive 2011/61/EU. In contrast, three types of situations can be identified where the loss should be deemed to be definitive: where the financial instrument no longer exists or never did exist; where the financial instrument exists but the AIF has definitively lost its right of ownership over it; and where the AIF has the ownership right but can no longer transfer title of or create limited property rights in the financial instrument on a permanent basis.

(115) A financial instrument is deemed no longer to exist for instance when it has disappeared following an accounting error that cannot be corrected, or if it never existed, when the AIF's ownership was registered on the basis of falsified documents. Situations where the loss of financial instruments is caused by fraudulent conduct should be deemed a loss.

(116) No loss can be ascertained when the financial instrument has been substituted by or converted into another financial instrument, for example in situations where shares are cancelled and replaced by the issue of new shares in a company reorganisation. An AIF should not be considered as permanently deprived of its right of ownership over the financial instrument if the AIF or the AIFM acting on behalf of the AIF has legitimately transferred ownership to a third party. Where there is a distinction between the legal ownership and the beneficial ownership of the assets, the definition of loss should refer to loss of the beneficial ownership right.

(117) Only in the case of an external event beyond the reasonable control of the depositary, the consequences of which are unavoidable despite all reasonable efforts to the contrary, could the depositary avoid to be held liable under Article 21(12) of Directive 2011/61/EU. The cumulative fulfilment of these conditions should be proven by the depositary in order for it to be discharged of liability.

(118) It should first be determined whether the event which led to the loss was external. The depositary's liability should not be affected by delegation and therefore an event should be deemed external if it does not occur as a result of any act or omission of the depositary or the third party to whom the custody of financial instruments held in custody has been delegated. Then, it should be assessed whether the event is beyond the reasonable control, by verifying that there was nothing a prudent depositary could reasonably have done to prevent the occurrence of the event. Under these steps both natural events and acts of a public authority may be considered as external events beyond reasonable control. Thus, in the context of the insolvency of a third party to whom custody was delegated, the law of the country where the instruments are held in custody, which does not recognise the effects of an appropriately implemented segregation, is deemed to be an external event beyond reasonable control. In contrast, a loss caused by failure to apply the segregation requirements laid down in Article 21(11)(d) (iii) of Directive 2011/61/EU or the loss of assets because of disruption in the third party's activity in relation to its insolvency cannot be seen as being external events beyond reasonable control.

(119) Finally, the depositary should prove that the loss could not have been avoided despite all reasonable efforts to the contrary. In this context, the depositary should inform the AIFM and take appropriate action depending on the circumstances. For instance, in a situation where the depositary believes the only appropriate action is to dispose of the financial instruments, the depositary should duly inform the AIFM, which must in turn instruct the depositary in writing whether to continue holding the financial instruments or to dispose of them. Any instruction to the depositary to continue holding the assets should be reported to the AIF's investors without undue delay. The AIFM or the AIF should give due consideration to the depositary's recommendations. Depending on the circumstances, if the depositary remains concerned that the standard of protection of the financial instrument is not sufficient, despite repeated warnings, it should consider further possible action, such as termination of the contract provided the AIF is given a period of time to find another depositary in accordance with national law.

(120) To ensure the same standard of investor protection, the same considerations should also apply to the delegate to whom a depositary has contractually transferred its liability. Therefore, in order to be discharged of liability under Article 21(12) of Directive 2011/61/EU the delegate should prove that it fulfils cumulatively the same conditions.

(121) A depositary is allowed under certain circumstances to discharge itself of liability for the loss of financial instruments held in custody by a third party to which custody was delegated. For such liability discharge to be permitted there must be an objective reason for contracting such discharge that is accepted by both the depositary and the AIF or the AIFM acting on behalf of the AIF. An objective reason should be established for each discharge of liability taking into account the concrete circumstances in which custody has been delegated.

(122) When considering an objective reason, the right balance should be established to ensure that the contractual discharge can be effectively relied upon if needed and that sufficient safeguards are put in place to avoid any misuse of the contractual discharge of liability by the depositary. The contractual discharge of liability should under no circumstances be used to circumvent the depositary's liability requirements under Directive 2011/61/EU. The depositary should demonstrate that it was forced by the specific circumstances to delegate custody to a third party. Contracting a discharge should be always in the best interest of the AIF or its investors, and the AIF or the AIFM acting on behalf of the AIF should make it explicit that they act in such best interest. Examples of scenarios should indicate the situations where a depositary may be considered as not having other options but to delegate custody to third parties.

(123) It is important for competent authorities to obtain appropriate and sufficient information in order to supervise activities of AIFMs and the risks related to them appropriately and consistently. Also, since the activities of AIFMs could have effects across borders and on the financial markets, competent authorities should monitor AIFMs and AIFs closely in order to take appropriate action to avoid the build-up of systemic risks. The increased transparency and consistency through provisions on reporting and disclosing relevant information as outlined in the implementing measures should make it possible for competent authorities to detect and respond to risks in the financial markets.

(124) It is essential for investors to obtain the minimum information necessary with respect to particular AIFMs and AIFs and their structure in order to be able to take the right investment decision tailored to their needs and risk appetite. That information should be clear, reliable, readily understandable and clearly presented, whereas the usefulness of the information is enhanced when it is comparable from AIFM to AIFM and AIF to AIF and from one period to the next. An AIFM should not engage in activities which might be detrimental to the objective understanding and practical use of the information to investors prior to its disclosure such as window dressing.

(125) It is necessary to set out a framework which provides for minimum standards with respect to annual reporting requirements, including key elements and a non-exhaustive list of items. Material changes in the information as referred to in Article 22(2)(d) of Directive 2011/61/EU should be disclosed in the annual report within the financial statements. In addition to the non-exhaustive list of underlying line items additional line items, headings and sub totals may be included where the presentation of these items is relevant for the understanding of an AIF's overall financial position or performance. Items of a dissimilar nature or function could be aggregated provided such items are individually not materially relevant. Those items could be aggregated under 'other category' such as 'other assets' or 'other liabilities'. Where line items do not apply to a particular AIF at all, they do not need to be presented. Regardless of the accounting standards followed in accordance with Directive 2011/61/EU, all assets should be valued at least once a year. The balance sheet or the statement of assets and liabilities under Directive 2011/61/EU should include, inter alia, cash and cash equivalents. Thus, cash equivalents should be considered highly liquid investments for the purpose of calculating the exposure of an AIF.

(126) With respect to the content and format of the report on activities for the financial year which has to be part of the annual report under Directive 2011/61/EU, the report should include a fair and balanced review of the activities of the AIF with a description of the principal risks and investments or economic uncertainties that it faces. That disclosure should not result in the publication of proprietary information of the AIF which would be to the detriment of the AIF and its investors. Therefore, if the publication of particular proprietary information would have such effect, it could be aggregated to a level that would avoid the detrimental effect and would not need to capture, for example, the performance or statistics of an individual portfolio company or investment that could lead to the disclosure of proprietary information of the AIF. This information should form part of the management report in so far as this is usually presented alongside the financial statements.

(127) With respect to the content and format of the disclosure of remuneration where information is presented at the level of the AIFM, further information should be provided by disclosing an allocation or breakdown of the total remuneration as it relates to the relevant AIF. This could be achieved through disclosure of the total AIFM remuneration data split into fixed and variable components, a statement that these data relate to the entire AIFM, and not to the AIF, the number of AIFs and UCITS funds managed by the AIFM and the total assets under management of such AIFs and UCITS with an overview of the remuneration policy and a reference to where the full remuneration policy of the AIFM is available at the request of investors. Further details may be provided by disclosure of the total variable remuneration funded by the AIF through payment by it of performance fees or carried interest, as the case may be. In addition to the remuneration disclosure, it may be appropriate for AIFMs to provide information relating to the financial and non-financial criteria of the remuneration policies and practices for relevant categories of staff to enable investors to assess existing incentives created.

(128) Where the AIF issues units, transfers of any assets to side pockets should be calculated, at the time of transfer, based on the number of units allocated on transfer of assets multiplied by the price per unit. The valuation basis should be clearly disclosed in all circumstances and include the date at which the valuation was performed.

(129) In order to manage liquidity AIFMs should be permitted to enter into borrowing arrangements on behalf of AIFs they manage. Those arrangements can be short term or more permanent. In the latter case it is more likely that such an arrangement would be a special arrangement for the purpose of managing illiquid assets.

(130) In line with the principle of differentiation, and recognising the diversity of types of AIFs, the disclosure to investors required of an AIFM should vary according to the type of AIF and would depend on other factors such as investment strategy and the portfolio composition.

(131) Directive 2011/61/EU requires AIFMs to provide certain information on a regular basis to the competent authority of their home Member State for each EU AIFs they manage and for each of the AIF they market in the Union. It is therefore important to further specify the information to be provided and the frequency of the reporting which depend on the value of assets under management in portfolios of AIFs managed by a given AIFM. Pro-forma reporting templates should be provided for and should be completed by the AIFM for the AIFs it manages. Where an entity which is authorised as an AIFM markets AIFs which are managed by other AIFMs, it does not act as the manager of those AIFs but as an intermediary as any investment firm covered by Directive 2004/39/EC. It therefore should not have to report for these AIFs, as this would lead to double- or multiple reporting. This reporting requirement should nevertheless apply to non-EU AIFMs that manage AIFs which are marketed in the Union.

(132) The threshold provided in this Regulation triggers only reporting requirements laid down in Article 24(4) of Directive 2011/61/EU. An AIF with a leverage ratio calculated in accordance with the commitment method of less than three times its net asset value would not be considered as employing leverage on a substantial basis. However, competent authorities may request additional information where necessary for the effective monitoring of systemic risks. Setting a reporting threshold also ensures that information relating to the build-up of systemic risk is collected throughout the Union in a consistent way and provides certainty to AIFMs.

(133) A competent authority's supervisory powers under Article 25(3) of Directive 2011/61/EU are exercised within the new supervisory system, forming part of what are ongoing supervisory processes and systemic risk assessments of AIFMs by competent authorities and the European supervisory authorities, with reference to the stability and integrity of the financial system. Competent authorities should make appropriate use of the information they receive and should impose limits to leverage employed by an AIFM or other restrictions on the management of the AIF with respect to the AIFs managed where they deem this necessary in order to ensure the stability and integrity of the financial system. The assessment of systemic risk is likely to vary depending on the economic environment, whereby any AIFM, with respect to the AIFs it manages, has the potential to be systemically relevant. It is therefore a basic requirement that competent authorities obtain all the information necessary to assess those situations appropriately in order to avoid the build-up of systemic risk. Competent authorities should then assess the information thoroughly and take appropriate measures.

(134) To allow EU AIFMs to manage and market non-EU AIFs and non-EU AIFMs to manage and market AIFs in the Union, Directive 2011/61/EU requires appropriate cooperation arrangements to be put in place with the relevant supervisory authorities of the third country where the non-EU AIF and, as the case may be, or the non-EU AIFM is established. Such cooperation arrangements should ensure at least an efficient exchange of information that allows Union competent authorities to carry out their duties in accordance with Directive 2011/61/EU.

(135) Cooperation arrangements should allow competent authorities to carry out their supervisory and enforcement duties in respect of third country entities. Cooperation arrangements should therefore set out a clear concrete framework for access to information, for the carrying out of on-site inspections, and for assistance to be provided by the third country authorities. The cooperation arrangements should make sure that information received may be shared with other competent authorities concerned as well as with ESMA and the ESRB.

(136) In order to allow competent authorities, AIFMs and depositaries to adapt to the new requirements contained in this Regulation so that they can be applied in an efficient and effective manner, the starting date of application of this Regulation should be aligned with the transposition date of Directive 2011/61/EU,

HAS ADOPTED THIS REGULATION:

CHAPTER I

DEFINITIONS

Article 1

Definitions

In addition to the definitions laid down in Article 2 of Directive 2011/61/EU, the following definitions apply for the purposes of this Regulation:

(1) 'capital commitment' means the contractual commitment of an investor to provide the alternative investment fund (AIF) with an agreed amount of investment on request by the AIFM;

(2) 'relevant person' in relation to an AIFM means any of the following:

(a) a director, partner or equivalent, or manager of the AIFM;

(b) an employee of the AIFM, or any other natural person whose services are placed at the disposal and under the control of the AIFM and who is involved in the provision of collective portfolio management services by the AIFM;

(c) a natural or legal person who is directly involved in the provision of services to the AIFM under a delegation arrangement to third parties for the purpose of the provision of collective portfolio management by the AIFM;

(3) 'senior management' means the person or persons who effectively conduct the business of an AIFM in accordance with Article 8(1)(c) of Directive 2011/61/EU and, as the case may be, the executive member or members of the governing body;

(4) 'governing body' means the body with ultimate decision making authority in an AIFM, comprising the supervisory and the managerial functions, or only the managerial function if the two functions are separated;

(5) 'special arrangement' means an arrangement that arises as a direct consequence of the illiquid nature of the assets of an AIF which impacts the specific redemption rights of investors in a type of units or shares of the AIF and which is a bespoke or separate arrangement from the general redemption rights of investors.

CHAPTER II

GENERAL PROVISIONS

SECTION 1

Calculation of assets under management

(Article 3(2) of Directive 2011/61/EU)

Article 2

Calculation of the total value of assets under management

1. In order to qualify for the exemption provided for in Article 3(2) of Directive 2011/61/EU an AIFM shall:

(a) identify all AIFs for which it is appointed as the external AIFM or the AIF for which it is the AIFM, where the legal form of the AIF permits internal management, in accordance with Article 5 of Directive 2011/61/EU;

(b) identify for each managed AIF the portfolio of assets and determine in accordance with the valuation rules laid down in the law of the country where the AIF is established and, as the case may be, or in the AIF rules or instruments of incorporation the corresponding value of assets under management, including all assets acquired through use of leverage;

(c) aggregate the determined values of assets under management for all AIFs managed and compare the resulting total value of assets under management to the relevant threshold laid down in Article 3(2) of Directive 2011/61/EU.

2. For the purposes of paragraph 1, undertakings for collective investment in transferable securities (UCITS) for which the AIFM acts as the designated management company under Directive 2009/65/EC shall not be included in the calculation.

For the purposes of paragraph 1, AIFs managed by the AIFM for which the AIFM has delegated functions in accordance with Article 20 of Directive 2011/61/EU shall be included in the calculation. However, portfolios of AIFs that the AIFM is managing under delegation shall be excluded from the calculation.

3. For the purpose of calculating the total value of assets under management, each derivative instrument position, including any derivative embedded in transferable securities shall be converted into its equivalent position in the underlying assets of that derivative using the conversion methodologies set out in Article 10. The absolute value of that equivalent position shall then be used for the calculation of the total value of assets under management.

4. Where an AIF invests in other AIFs managed by the same externally appointed AIFM, that investment may be excluded from the calculation of the AIFM's assets under management.

5. Where one compartment within an internally or externally managed AIF invests in another compartment of that AIF, that investment may be excluded from the calculation of the AIFMs assets under management.

6. The total value of assets under management shall be calculated in accordance with paragraphs 1 to 4 at least annually and using the latest available asset values. The latest available asset value for each AIF shall be produced during the 12 months preceding the date of the calculation of the threshold in accordance with the first sentence of this paragraph. The AIFM shall determine a threshold calculation date and apply it in a consistent manner. Any subsequent change to the date chosen must be justified to the competent authority. In selecting the threshold calculation date, the AIFM shall take into account the time and frequency of the valuation of the assets under management.

Article 3

Ongoing monitoring of assets under management

AIFMs shall establish, implement and apply procedures to monitor on an ongoing basis the total value of assets under management. Monitoring shall reflect an up-to-date overview of the assets under management and shall include the observation of subscription and redemption activity or, where applicable, capital draw downs, capital distributions and the value of the assets invested in for each AIF.

The proximity of the total value of assets under management to the threshold set in Article 3(2) of Directive 2011/61/EU and the anticipated subscription and redemption activity shall be taken into account in order to assess the need for more frequent calculations of the total value of assets under management.

Article 4

Occasional breach of the threshold

1. The AIFM shall assess situations where the total value of assets under management exceeds the relevant threshold in order to determine whether or not they are of a temporary nature.

2. Where the total value of assets under management exceeds the relevant threshold and the AIFM considers that the situation is not of a temporary nature, the AIFM shall notify the competent authority without delay stating that the situation is considered not to be of a temporary nature and shall seek authorisation within 30 calendar days in accordance with Article 7 of Directive 2011/61/EU.

3. Where the total value of assets under management exceeds the relevant threshold and the AIFM considers that the situation is of a temporary nature, the AIFM shall notify the competent authority without delay, stating that the situation is considered to be of a temporary nature. The notification shall include supporting information to justify the AIFM's assessment of the temporary nature of the situation, including a description of the situation and an explanation of the reasons for considering it temporary.

4. A situation shall not be considered of a temporary nature if it is likely to continue for a period in excess of three months.

5. Three months after the date on which the total value of assets under management exceeds the relevant threshold the AIFM shall recalculate the total value of assets under management in order to demonstrate that it is below the relevant threshold or demonstrate to the competent authority that the situation which resulted in the assets under management exceeding the threshold has been resolved and an application for authorisation of the AIFM is not required.

Article 5

Information to be provided as part of registration

1. As part of the requirement in Article 3(3)(b) of Directive 2011/61/EU, AIFMs shall communicate to the competent authorities the total value of assets under management calculated in accordance with the procedure set out in Article 2.

2. As part of the requirement in Article 3(3)(c) of Directive 2011/61/EU AIFMs shall provide for each AIF the offering document or a relevant extract from the offering document or a general description of the investment strategy. The relevant extract from the offering document and the description of the investment strategy shall include at least the following information:

(a) the main categories of assets in which the AIF may invest;

(b) any industrial, geographic or other market sectors or specific classes of assets which are the focus of the investment strategy;

(c) a description of the AIF's borrowing or leverage policy.

3. Information to be provided by the AIFM under point (d) of Article 3(3) of Directive 2011/61/EU is listed in Article 110(1) of this Regulation. It shall be provided in accordance with the pro-forma reporting template as set out in the Annex IV.

4. Information collected in accordance with Article 3(3)(d) of Directive 2011/61/EU shall be shared between competent authorities in the Union, with the European Securities and Markets Authority (ESMA) and the European Systemic Risk Board (ESRB) where necessary for the fulfilment of their duties.

5. The information required for registration purposes shall be updated and provided on an annual basis. For reasons relating to the exercise of their powers under Article 46 of Directive 2011/61/EU, the competent authorities may require an AIFM to provide the information referred to in Article 3 of Directive 2011/61/EU on a more frequent basis.

SECTION 2

Calculation of leverage

(Article 4(3) of Directive 2011/61/EU)

Article 6

General provisions on the calculation of leverage

1. Leverage of an AIF shall be expressed as the ratio between the exposure of an AIF and its net asset value.

2. AIFMs shall calculate the exposure of the AIFs managed in accordance with the gross method as set out in Article 7 and the commitment method as set out in Article 8.

The Commission shall review, in the light of market developments and no later than 21 July 2015, the calculation methods referred to in the first subparagraph in order to decide whether these methods are sufficient and appropriate for all types of AIFs, or an additional and optional method for calculating leverage should be developed.

3. Exposure contained in any financial or legal structures involving third parties controlled by the relevant AIF shall be included in the calculation of the exposure where the structures referred to are specifically set up to directly or indirectly increase the exposure at the level of the AIF. For AIFs whose core investment policy is to acquire control of non-listed companies or issuers, the AIFM shall not include in the calculation of the leverage any exposure that exists at the level of those non-listed companies and issuers provided that the AIF or the AIFM acting on behalf of the AIF does not have to bear potential losses beyond its investment in the respective company or issuer.

4. AIFMs shall exclude borrowing arrangements entered into if these are temporary in nature and are fully covered by contractual capital commitments from investors in the AIF.

5. An AIFM shall have appropriately documented procedures to calculate the exposure of each AIF under its management in accordance with the gross method and the commitment method. The calculation shall be applied consistently over time.

Article 7

Gross method for calculating the exposure of the AIF

The exposure of an AIF calculated in accordance with the gross method shall be the sum of the absolute values of all positions valued in accordance with Article 19 of Directive 2011/61/EU and all delegated acts adopted pursuant to it.

For the calculation of the exposure of an AIF in accordance with the gross method an AIFM shall:

(a) exclude the value of any cash and cash equivalents which are highly liquid investments held in the base currency of the AIF, that are readily convertible to a known amount of cash, are subject to an insignificant risk of change in value and provide a return no greater than the rate of a three-month high quality government bond;

(b) convert derivative instruments into the equivalent position in their underlying assets using the conversion methodologies set out in Article 10 and the methods set out in paragraphs (4) to (9) and (14) of Annex I;

(c) exclude cash borrowings that remain in cash or cash equivalent as referred to in point (a) and where the amounts of that payable are known;

(d) include exposure resulting from the reinvestment of cash borrowings, expressed as the higher of the market value of the investment realised or the total amount of the cash borrowed as referred to in paragraphs (1) and (2) of Annex I;

(e) include positions within repurchase or reverse repurchase agreements and securities lending or borrowing or other arrangements in accordance with paragraphs (3) and (10) to (13) of Annex I.

Article 8

Commitment method for calculating the exposure of an AIF

1. The exposure of an AIF calculated in accordance with the commitment method shall be the sum of the absolute values of all positions valued in accordance with Article 19 of Directive 2011/61/EU and its corresponding delegated acts, subject to the criteria provided for in paragraphs 2 to 9.

2. For the calculation of the exposure of an AIF in accordance with the commitment method an AIFM 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 paragraphs (4) to (9) and (14) of Annex II;

(b) apply netting and hedging arrangements;

(c) calculate the exposure created through the reinvestment of borrowings where such reinvestment increases the exposure of the AIF as defined in paragraphs (1) and (2) of Annex I;

(d) include other arrangements in the calculation in accordance with paragraphs (3) and (10) to (13) of Annex I.

3. 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 arrangements 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.

4. By way of derogation from paragraph 2, a derivative instrument shall not be converted into an equivalent position in the underlying asset if it has all of the following characteristics:

(a) it swaps the performance of financial assets held in the AIF's portfolio for the performance of other reference financial assets;

(b) it totally offsets the risks of the swapped assets held in the AIF's portfolio so that the AIF's performance does not depend on the performance of the swapped assets;

(c) it includes neither additional optional features, nor leverage clauses nor other additional risks as compared to a direct holding of the reference financial assets.

5. By way of derogation from paragraph 2, a derivative instrument shall not be converted into an equivalent position in the underlying asset when calculating the exposure according to the commitment method if it meets both of the following conditions:

(a) the combined holding by the AIF of a derivative instrument relating to a financial asset and cash which is invested in cash equivalent as defined in Article 7(a) is equivalent to holding a long position in the given financial asset;

(b) the derivative instrument shall not generate any incremental exposure and leverage or risk.

6. Hedging arrangements shall be taken into account when calculating the exposure of an AIF only if they comply with all the following conditions:

(a) the positions involved within the hedging relationship do not aim to generate a return and general and specific risks are offset;

(b) there is a verifiable reduction of market risk at the level of the AIF;

(c) the risks linked to derivative instruments, general and specific, if any, are offset;

(d) the hedging arrangements relate to the same asset class;

(e) they are efficient in stressed market conditions.

7. Subject to paragraph 6, derivative instruments used for currency hedging purposes and that do not add any incremental exposure, leverage or other risks shall not be included in the calculation.

8. An AIFM shall net positions in any of the following cases:

(a) between derivative instruments, provided they refer to the same underlying asset, even if the maturity date of the derivative instruments is different;

(b) between a derivative instrument whose underlying asset is a transferable security, money market instrument or units in a collective investment undertaking as referred to in points 1 to 3 of Section C of Annex I to Directive 2004/39/EC, and that same corresponding underlying asset.

9. AIFMs managing AIFs that, in accordance with their core investment policy, primarily invest in interest rate derivatives shall make use of specific duration netting rules in order to take into account the correlation between the maturity segments of the interest rate curve as set out in Article 11.

Article 9

Methods of increasing the exposure of an AIF

When calculating exposure AIFMs shall use the methods set out in Annex I for the situations referred to therein.

Article 10

Conversion methodologies for derivative instruments

AIFMs shall use the conversion methodologies set out in Annex II for the derivative instruments referred to therein.

Article 11

Duration netting rules

1. Duration netting rules shall be applied by AIFMs when calculating the exposure of AIFs according to Article 8(9).

2. The duration-netting rules shall not be used where they would lead to a misrepresentation of the risk profile of the AIF. AIFMs availing themselves of those netting rules shall not include other sources of risk such as volatility in their interest rate strategy. Consequently, interest rate arbitrage strategies shall not apply those netting rules.

3. The use of those duration-netting rules shall not generate any unjustified level of leverage through investment in short-term positions. Short-dated interest rate derivatives shall not be the main source of performance for an AIF with medium duration which uses the duration netting rules.

4. Interest rate derivatives shall be converted into their equivalent underlying asset position and netted in accordance with Annex III.

5. An AIF making use of the duration-netting rules may still make use of the hedging framework. Duration netting rules may be applied only to the interest rate derivatives which are not included in hedging arrangements.

SECTION 3

Additional own funds and professional indemnity insurance

(Article 9(7) and Article 15 of Directive 2011/61/EU)

Article 12

Professional liability risks

1. The professional liability risks to be covered pursuant to Article 9(7) of Directive 2011/61/EU shall be risks of loss or damage caused by a relevant person through the negligent performance of activities for which the AIFM has legal responsibility.

2. Professional liability risks as defined in paragraph 1 shall include, without being limited to, risks of:

(a) loss of documents evidencing title of assets of the AIF;

(b) misrepresentations or misleading statements made to the AIF or its investors;

(c) acts, errors or omissions resulting in a breach of:

(i) legal and regulatory obligations;

(ii) duty of skill and care towards the AIF and its investors;

(iii) fiduciary duties;

(iv) obligations of confidentiality;

(v) AIF rules or instruments of incorporation;

(vi) terms of appointment of the AIFM by the AIF;

(d) failure to establish, implement and maintain appropriate procedures to prevent dishonest, fraudulent or malicious acts;

(e) improperly carried out valuation of assets or calculation of unit/share prices;

(f) losses arising from business disruption, system failures, failure of transaction processing or process management.

3. Professional liability risks shall be covered at all times either through appropriate additional own funds determined in accordance with Article 14 or through appropriate coverage of professional indemnity insurance determined in accordance with Article 15.

Article 13

Qualitative requirements addressing professional liability risks

1. An AIFM shall implement effective internal operational risk management policies and procedures in order to identify, measure, manage and monitor appropriately operational risks including professional liability risks to which the AIFM is or could be reasonably exposed. The operational risk management activities shall be performed independently as part of the risk management policy.

2. An AIFM shall set up a historical loss database, in which any operational failures, loss and damage experience shall be recorded. This database shall record, without being limited to, any professional liability risks as referred to in Article 12(2) that have materialised.

3. Within the risk management framework the AIFM shall make use of its internal historical loss data and where appropriate of external data, scenario analysis and factors reflecting the business environment and internal control systems.

4. Operational risk exposures and loss experience shall be monitored on an ongoing basis and shall be subject to regular internal reporting.

5. An AIFM's operational risk management policies and procedures shall be well documented. An AIFM shall have arrangements in place for ensuring compliance with its operational risk management policies and effective measures for the treatment of non-compliance with these policies. An AIFM shall have procedures in place for taking appropriate corrective action.

6. The operational risk management policies and procedures and measurement systems shall be subject to regular review, at least on an annual basis.

7. An AIFM shall maintain financial resources adequate to its assessed risk profile.

Article 14

Additional own funds

1. This Article shall apply to AIFMs that choose to cover professional liability risks through additional own funds.

2. The AIFM shall provide additional own funds for covering liability risks arising from professional negligence at least equal to 0,01 % of the value of the portfolios of AIFs managed.

The value of the portfolios of AIFs managed shall be the sum of the absolute value of all assets of all AIFs managed by the AIFM, including assets acquired through use of leverage, whereby derivative instruments shall be valued at their market value.

3. The additional own funds requirement referred to in paragraph 2 shall be recalculated at the end of each financial year and the amount of additional own funds shall be adjusted accordingly.

The AIFM shall establish, implement and apply procedures to monitor on an ongoing basis the value of the portfolios of AIFs managed, calculated in accordance with the second subparagraph of paragraph 2. Where, before the annual recalculation referred to in the first subparagraph, the value of the portfolios of AIFs managed increases significantly, the AIFM shall without undue delay recalculate the additional own funds requirement and shall adjust the additional own funds accordingly.

4. The competent authority of the home Member State of the AIFM may authorise the AIFM to provide additional own funds lower than the amount referred to in paragraph 2 only if it is satisfied — on the basis of the historical loss data of the AIFM as recorded over an observation period of at least three years prior to the assessment — that the AIFM provides sufficient additional own funds to appropriately cover professional liability risks. The authorised lower amount of additional own funds shall be not less than 0,008 % of the value of the portfolios of AIFs managed by the AIFM.

5. The competent authority of the home Member State of the AIFM may request the AIFM to provide additional own funds higher than the amount referred to in paragraph 2 if it is not satisfied that the AIFM has sufficient additional own funds to appropriately cover professional liability risks. The competent authority shall give reasons why it considers that the AIFM's additional own funds are insufficient.

Article 15

Professional indemnity insurance

1. This Article shall apply to AIFMs that choose to cover professional liability risks through professional indemnity insurance.

2. The AIFM shall take out and maintain at all times professional indemnity insurance that:

(a) shall have an initial term of no less than one year;

(b) shall have a notice period for cancellation of at least 90 days;

(c) shall cover professional liability risks as defined in Article 12(1) and (2);

(d) is taken out from an EU or non-EU undertaking authorised to provide professional indemnity insurance, in accordance with Union law or national law;

(e) is provided by a third party entity.

Any agreed defined excess shall be fully covered by own funds which are in addition to the own funds to be provided in accordance with Article 9(1) and (3) of Directive 2011/61/EU.

3. The coverage of the insurance for an individual claim shall be equal to at least 0,7 % of the value of the portfolios of AIFs managed by the AIFM calculated as set out in the second subparagraph of Article 14(2).

4. The coverage of the insurance for claims in aggregate per year shall be equal to at least 0,9 % of the value of the portfolios of AIFs managed by the AIFM calculated as set out in the second subparagraph of Article 14(2).

5. The AIFM shall review the professional indemnity insurance policy and its compliance with the requirements laid down in this Article at least once a year and in the event of any change which affects the policy's compliance with the requirements in this Article.

CHAPTER III

OPERATING CONDITIONS FOR AIFMs

SECTION 1

General principles

(Article 12(1) of Directive 2011/61/EU)

Article 16

General obligations for competent authorities

When assessing the AIFM's compliance with Article 12(1) of Directive 2011/61/EU, the competent authorities shall use at least the criteria laid down in this Section.

Article 17

Duty to act in the best interests of the AIF or the investors in the AIF and the integrity of the market

1. AIFMs shall apply policies and procedures for preventing malpractices, including those that might reasonably be expected to affect adversely the stability and integrity of the market.

2. AIFMs shall ensure that the AIFs they manage or the investors in these AIFs are not charged undue costs.

Article 18

Due diligence

1. AIFMs shall apply a high standard of diligence in the selection and ongoing monitoring of investments.

2. AIFMs shall ensure that they have adequate knowledge and understanding of the assets in which the AIF is invested.

3. AIFMs shall establish, implement and apply written policies and procedures on due diligence and implement effective arrangements for ensuring that investment decisions on behalf of the AIFs are carried out in compliance with the objectives, the investment strategy and, where applicable, the risk limits of the AIF.

4. The policies and procedures on due diligence referred to in paragraph 3 shall be regularly reviewed and updated.

Article 19

Due diligence when investing in assets of limited liquidity

1. Where AIFMs invest in assets of limited liquidity and where such investment is preceded by a negotiation phase, they shall, in relation to the negotiation phase, in addition to the requirements laid down in Article 18:

(a) set out and regularly update a business plan consistent with the duration of the AIF and market conditions;

(b) seek and select possible transactions consistent with the business plan referred to in point (a);

(c) assess the selected transactions in consideration of opportunities, if any, and overall related risks, all relevant legal, tax-related, financial or other value affecting factors, human and material resources, and strategies, including exit strategies;

(d) perform due diligence activities related to the transactions prior to arranging execution;

(e) monitor the performance of the AIF with respect to the business plan referred to in point (a).

2. AIFMs shall retain records of the activities carried out pursuant to paragraph 1 for at least five years.

Article 20

Due diligence in the selection and appointment of counterparties and prime brokers

1. When selecting and appointing counterparties and prime brokers, AIFMs shall exercise due skill, care and diligence before entering into an agreement and on an ongoing basis thereafter taking into account the full range and quality of their services.

2. When selecting prime brokers or counterparties of an AIFM or an AIF in an OTC derivatives transaction, in a securities lending or in a repurchase agreement, AIFMs shall ensure that those prime brokers and counterparties fulfil all of the following conditions:

(a) they are subject to ongoing supervision by a public authority;

(b) they are financially sound;

(c) they have the necessary organisational structure and resources for performing the services which are to be provided by them to the AIFM or the AIF.

3. When appraising the financial soundness referred to in paragraph 2(b), the AIFM shall take into account whether or not the prime broker or counterparty is subject to prudential regulation, including sufficient capital requirements, and effective supervision.

4. The list of selected prime brokers shall be approved by the AIFM's senior management. In exceptional cases prime brokers not included in the list may be appointed provided that they fulfil the requirements laid down in paragraph 2 and subject to approval by senior management. The AIFM shall be able to demonstrate the reasons for such a choice and the due diligence that it exercised in selecting and monitoring the prime brokers which had not been listed.

Article 21

Acting honestly, fairly and with due skills

In order to establish whether an AIFM conducts its activities honestly, fairly and with due skills, competent authorities shall assess, at least, whether the following conditions are met:

(a) the governing body of the AIFM possesses adequate collective knowledge, skills and experience to be able to understand the AIFM's activities, in particular the main risks involved in those activities and the assets in which the AIF is invested;

(b) the members of the governing body commit sufficient time to properly perform their functions in the AIFM;

(c) each member of the governing body acts with honesty, integrity and independence of mind;

(d) the AIFM devotes adequate resources to the induction and training of members of the governing body.

Article 22

Resources

1. AIFMs shall employ sufficient personnel with the skills, knowledge and expertise necessary for discharging the responsibilities allocated to them.

2. For the purposes of paragraph 1, AIFMs shall take into account the nature, scale and complexity of their business and the nature and range of services and activities undertaken in the course of that business.

Article 23

Fair treatment of investors in the AIF

1. The AIFM shall ensure that its decision-making procedures and its organisational structure, referred to in Article 57, ensure fair treatment of investors.

2. Any preferential treatment accorded by an AIFM to one or more investors shall not result in an overall material disadvantage to other investors.

Article 24

Inducements

1. AIFMs shall not be regarded as acting honestly, fairly and in accordance with the best interests of the AIFs they manage or the investors in these AIFs if, in relation to the activities performed when carrying out the functions referred to in Annex I to Directive 2011/61/EU, they pay or are paid any fee or commission, or provide or are provided with any non-monetary benefit, other than the following:

(a) a fee, commission or non-monetary benefit paid or provided to or by the AIF or a person on behalf of the AIF;

(b) a fee, commission or non-monetary benefit paid or provided to or by a third party or a person acting on behalf of a third party, where the AIFM can demonstrate that the following conditions are satisfied:

(i) the existence, nature and amount of the fee, commission or benefit, or, where the amount cannot be ascertained, the method of calculating that amount, is clearly disclosed to the investors in the AIF in a manner that is comprehensive, accurate and understandable, prior to the provision of the relevant service;

(ii) the payment of the fee or commission, or the provision of the non-monetary benefit are designed to enhance the quality of the relevant service and not impair compliance with the AIFM's duty to act in the best interests of the AIF it manages or the investors in the AIF;

(c) proper fees which enable or are necessary for the provision of the relevant service, including custody costs, settlement and exchange fees, regulatory levies or legal fees, and which, by their nature, do not give rise to conflicts with the AIFM's duties to act honestly, fairly and in accordance with the best interests of the AIF it manages or the investors of the AIF.

2. The disclosure of the essential terms of the arrangements relating to the fee, commission or non-monetary benefit in summary form shall be considered as satisfactory for the purposes of point (i) of paragraph 1(b), provided that the AIFM commits to disclose further details at the request of the investor in the AIF it manages and provided that it fulfils this commitment.

Article 25

Effective employment of resources and procedures — handling of orders

1. AIFMs shall establish, implement and apply procedures and arrangements which provide for the prompt, fair and expeditious execution of orders on behalf of the AIF.

2. The procedures and arrangements referred to in paragraph 1 shall satisfy the following requirements:

(a) they shall ensure that orders executed on behalf of AIFs are promptly and accurately recorded and allocated;

(b) they shall execute otherwise comparable AIF orders sequentially and promptly unless the characteristics of the order or prevailing market conditions make this impracticable, or the interests of the AIF or of the investors in the AIF require otherwise.

3. The financial instruments, sums of money or other assets received in settlement of the executed orders shall be promptly and correctly delivered to or registered in the account of the relevant AIF.

4. AIFMs shall not misuse information related to pending AIF orders, and shall take all reasonable steps to prevent the misuse of such information by any of their relevant persons.

Article 26

Reporting obligations in respect of execution of subscription and redemption orders

1. Where AIFMs have carried out a subscription or, where relevant, a redemption order from an investor, they shall promptly provide the investor, by means of a durable medium, with the essential information concerning the execution of that order or the acceptance of the subscription offer, as the case may be.

2. Paragraph 1 shall not apply where a third person is required to provide the investor with a confirmation concerning the execution of the order and where the confirmation contains the essential information.

AIFMs shall ensure that the third person complies with its obligations.

3. The essential information referred to in paragraphs 1 and 2 shall include the following information:

(a) the identification of the AIFM;

(b) the identification of the investor;

(c) the date and time of receipt of the order;

(d) the date of execution;

(e) the identification of the AIF;

(f) the gross value of the order including charges for subscription or the net amount after charges for redemptions.

4. AIFMs shall supply the investor, upon request, with information about the status of the order or the acceptance of the subscription offer, or both as the case may be.

Article 27

Execution of decisions to deal on behalf of the managed AIF

1. AIFMs shall act in the best interests of the AIFs or the investors in the AIFs they manage when executing decisions to deal on behalf of the managed AIF in the context of the management of their portfolio.

2. Whenever AIFMs buy or sell financial instruments or other assets for which best execution is relevant, and for the purposes of paragraph 1, they shall take all reasonable steps to obtain the best possible result for the AIFs they manage or the investors in these AIFs, taking into account price, costs, speed, likelihood of execution and settlement, size, nature or any other consideration relevant to the execution of the order. The relative importance of such factors shall be determined by reference to the following criteria:

(a) the objectives, investment policy and risks specific to the AIF, as indicated in the AIF's rules or articles of association, prospectus or offering documents of the AIF;

(b) the characteristics of the order;

(c) the characteristics of the financial instruments or other assets that are the subject of that order;

(d) the characteristics of the execution venues to which that order can be directed.

3. AIFMs shall establish and implement effective arrangements for complying with the obligations referred to in paragraphs 1 and 2. In particular, the AIFM shall establish in writing and implement an execution policy to allow AIFs and their investors to obtain, for AIF orders, the best possible result in accordance with paragraph 2.

4. AIFMs shall monitor on a regular basis the effectiveness of their arrangements and policy for the execution of orders with a view to identifying and, where appropriate, correcting any deficiencies.

5. AIFMs shall review their execution policy on an annual basis. A review shall also be carried out whenever a material change occurs that affects the AIFM's ability to continue to obtain the best possible result for the managed AIFs.

6. AIFMs shall be able to demonstrate that they have executed orders on behalf of the AIF in accordance with their execution policy.

7. Whenever there is no choice of different execution venues paragraphs 2 to 5 shall not apply. However, AIFMs shall be able to demonstrate that there is no choice of different execution venues.

Article 28

Placing orders to deal on behalf of AIFs with other entities for execution

1. Whenever the AIFM buys or sells financial instruments or other assets for which best execution is relevant, it shall act in the best interest of the AIFs it manages or the investors in the AIFs when placing orders to deal on behalf of the managed AIFs with other entities for execution, in the context of the management of their portfolio.

2. AIFMs shall take all reasonable steps to obtain the best possible result for the AIF or the investors in the AIF taking into account price, costs, speed, likelihood of execution and settlement, size, nature or any other consideration relevant to the execution of the order. The relative importance of such factors shall be determined by reference to the criteria laid down in Article 27(2).

AIFMs shall establish, implement and apply a policy to enable them to comply with the obligation referred to in the first subparagraph. The policy shall identify, in respect of each class of instruments, the entities with which the orders may be placed. The AIFM shall only enter into arrangements for execution where such arrangements are consistent with the obligations laid down in this Article. The AIFM shall make available to investors in the AIFs it manages appropriate information on the policy established in accordance with this paragraph and on any material changes to that policy.

3. AIFMs shall monitor on a regular basis the effectiveness of the policy established in accordance with paragraph 2 and, in particular, the quality of the execution by the entities identified in that policy and, where appropriate, correct any deficiencies.

In addition, AIFMs shall review the policy on an annual basis. Such a review shall also be carried out whenever a material change occurs that affects the AIFM's ability to continue to obtain the best possible result for the managed AIFs.

4. AIFMs shall be able to demonstrate that they have placed orders on behalf of the AIF in accordance with the policy established pursuant to paragraph 2.

5. Whenever there is no choice of different execution venues paragraphs 2 to 5 shall not apply. However, AIFMs shall be able to demonstrate that there is no choice of different execution venues.

Article 29

Aggregation and allocation of trading orders

1. AIFMs can only carry out an AIF order in aggregate with an order of another AIF, a UCITS or a client or with an order made when investing their own funds where:

(a) it can be reasonably expected that the aggregation of orders will not work overall to the disadvantage of any AIF, UCITS or clients whose order is to be aggregated;

(b) an order allocation policy is established and implemented, providing in sufficiently precise terms for the fair allocation of aggregated orders, including how the volume and price of orders determines allocations and the treatment of partial executions.

2. Where an AIFM aggregates an AIF order with one or more orders of other AIFs, UCITS or clients and the aggregated order is partially executed, it shall allocate the related trades in accordance with its order allocation policy.

3. Where an AIFM aggregates transactions for its own account with one or more orders of AIFs, UCITS or clients, it shall not allocate the related trades in a way that is detrimental to the AIF, UCITS or a client.

4. Where an AIFM aggregates an order of an AIF, UCITS or another client with a transaction for its own account and the aggregated order is partially executed, it shall allocate the related trades to the AIF, UCITS or to clients in priority over those for own account.

However, if the AIFM is able to demonstrate to the AIF or to the client on reasonable grounds that it would not have been able to carry out the order on such advantageous terms without aggregation, or at all, it may allocate the transaction for its own account proportionally, in accordance with the policy referred to in point (b) of paragraph 1.

SECTION 2

Conflicts of interest

(Article 14 of Directive 2011/61/EU)

Article 30

Types of conflicts of interest

For the purpose of identifying the types of conflicts of interest that arise in the course of managing an AIF, AIFMs shall take into account, in particular, whether the AIFM, a relevant person or a person directly or indirectly linked by way of control to the AIFM:

(a) is likely to make a financial gain, or avoid a financial loss, at the expense of the AIF or its investors;

(b) has an interest in the outcome of a service or an activity provided to the AIF or its investors or to a client or of a transaction carried out on behalf of the AIF or a client, which is distinct from the AIF's interest in that outcome;

(c) has a financial or other incentive to favour:

— the interest of a UCITS, a client or group of clients or another AIF over the interest of the AIF,

— the interest of one investor over the interest of another investor or group of investors in the same AIF;

(d) carries out the same activities for the AIF and for another AIF, a UCITS or client; or

(e) receives or will receive from a person other than the AIF or its investors an inducement in relation to collective portfolio management activities provided to the AIF, in the form of monies, goods or services other than the standard commission or fee for that service.

Article 31

Conflicts of interest policy

1. The AIFM shall establish, implement and apply an effective conflicts of interest policy. That policy shall be set out in writing and shall be appropriate to the size and organisation of the AIFM and the nature, scale and complexity of its business.

Where the AIFM is a member of a group, the policy shall also take into account any circumstances of which the AIFM is or should be aware which may give rise to a conflict of interest resulting from the structure and business activities of other members of the group.

2. The conflicts of interest policy established in accordance with paragraph 1 shall include the following:

(a) with reference to the activities carried out by or on behalf of the AIFM, including activities carried out by a delegate, sub-delegate, external valuer or counterparty, identification of the circumstances which constitute or may give rise to a conflict of interest entailing a material risk of damage to the interests of the AIF or its investors;

(b) procedures to be followed and measures to be adopted in order to prevent, manage and monitor such conflicts.

Article 32

Conflicts of interest related to the redemption of investments

The AIFM that manages an open-ended AIF shall identify, manage and monitor conflicts of interest arising between investors wishing to redeem their investments and investors wishing to maintain their investments in the AIF, and any conflicts between the AIFM's incentive to invest in illiquid assets and the AIF's redemption policy in accordance with its obligations under Article 14(1) of Directive 2011/61/EU.

Article 33

Procedures and measures preventing or managing conflicts of interest

1. The procedures and measures established for the prevention or management of conflicts of interest shall be designed to ensure that the relevant persons engaged in different business activities involving a risk of conflict of interest carry out these activities having a degree of independence which is appropriate to the size and activities of the AIFM and of the group to which it belongs, and to the materiality of the risk of damage to the interests of the AIF or its investors.

2. Where necessary and appropriate for the AIFM to ensure the requisite degree of independence, the procedures to be followed and measures to be adopted in accordance with point (b) of Article 31(2) shall include the following:

(a) effective procedures to prevent or control the exchange of information between relevant persons engaged in collective portfolio management activities or other activities pursuant to Article 6(2) and (4) of Directive 2011/61/EU involving a risk of conflict of interest where the exchange of information may harm the interest of one or more AIFs or their investors;

(b) the separate supervision of relevant persons, whose principal functions involve carrying out collective portfolio management activities on behalf of, or providing services to, clients or investors, whose interests may conflict, or who otherwise represent different interests that may conflict, including those of the AIFM;

(c) the removal of any direct link between the remuneration of relevant persons principally engaged in one activity and the remuneration of, or revenues generated by, different relevant persons principally engaged in another activity, where a conflict of interest may arise in relation to those activities;

(d) measures to prevent or restrain any person from exercising inappropriate influence over the way in which a relevant person carries out collective portfolio management activities;

(e) measures to prevent or control the simultaneous or sequential involvement of a relevant person in separate collective portfolio management activities or other activities pursuant to Article 6(2) and (4) of Directive 2011/61/EU where such involvement may impair the proper management of conflicts of interest.

Where the adoption or the application of one or more of those measures and procedures does not ensure the requisite degree of independence, the AIFM shall adopt such alternative or additional measures and procedures as are necessary and appropriate for those purposes.

Article 34

Managing conflicts of interest

Where the organisational or administrative arrangements made by the AIFM are not sufficient to ensure, with reasonable confidence, that risks of damage to the interests of the AIF or investors in the AIF are prevented, the senior management or other competent internal body of the AIFM shall be promptly informed in order to take any necessary decision or action to ensure that the AIFM acts in the best interests of the AIF or the investors in that AIF.

Article 35

Monitoring conflicts of interest

1. The AIFM shall keep and regularly update a record of the types of activities undertaken by or on behalf of the AIFM in which a conflict of interest entailing a material risk of damage to the interests of one or more AIFs or its investors has arisen or, in the case of an ongoing activity, may arise.

2. Senior management shall receive on a frequent basis, and at least annually, written reports on activities referred to in paragraph 1.

Article 36

Disclosure of conflicts of interest

1. The information to be disclosed to investors in accordance with Article 14(1) and (2) of Directive 2011/61/EU shall be provided to investors in a durable medium or by means of a website.

2. Where information referred to in paragraph 1 is provided by means of a website and is not addressed personally to the investor, the following conditions shall be satisfied:

(a) the investor has been notified of the address of the website, and the place on the website where the information may be accessed, and has consented to the provision of the information by such means;

(b) the information must be up to date;

(c) the information must be accessible continuously by means of that website for such period of time as the investor may reasonably need to inspect it.

Article 37

Strategies for the exercise of voting rights

1. An AIFM shall develop adequate and effective strategies for determining when and how any voting rights held in the AIF portfolios it manages are to be exercised, to the exclusive benefit of the AIF concerned and its investors.

2. The strategy referred to in paragraph 1 shall determine measures and procedures for:

(a) monitoring relevant corporate actions;

(b) ensuring that the exercise of voting rights is in accordance with the investment objectives and policy of the relevant AIF;

(c) preventing or managing any conflicts of interest arising from the exercise of voting rights.

3. A summary description of the strategies and details of the actions taken on the basis of those strategies shall be made available to the investors on their request.

SECTION 3

Risk management

(Article 15 of Directive 2011/61/EU)

Article 38

Risk management systems

For the purposes of this Section, risk management systems shall be understood as systems comprised of relevant elements of the organisational structure of the AIFM, with a central role for a permanent risk management function, policies and procedures related to the management of risk relevant to each AIF's investment strategy, and arrangements, processes and techniques related to risk measurement and management employed by the AIFM in relation to each AIF it manages.

Article 39

Permanent risk management function

1. An AIFM shall establish and maintain a permanent risk management function that shall:

(a) implement effective risk management policies and procedures in order to identify, measure, manage and monitor on an ongoing basis all risks relevant to each AIF's investment strategy to which each AIF is or may be exposed;

(b) ensure that the risk profile of the AIF disclosed to investors in accordance with point (c) of Article 23(4) of Directive 2011/61/EU is consistent with the risk limits that have been set in accordance with Article 44 of this Regulation;

(c) monitor compliance with the risk limits set in accordance with Article 44 and notify the AIFM's governing body and, where it exists, the AIFM's supervisory function in a timely manner when it considers the AIF's risk profile inconsistent with these limits or sees a material risk that the risk profile will become inconsistent with these limits;

(d) provide the following regular updates to the governing body of the AIFM and where it exists the AIFM's supervisory function at a frequency which is in accordance with the nature, scale and complexity of the AIF or the AIFM's activities:

(i) the consistency between and compliance with the risk limits set in accordance with Article 44 and the risk profile of the AIF as disclosed to investors in accordance with Article 23(4)(c) of Directive 2011/61/EU;

(ii) the adequacy and effectiveness of the risk management process, indicating in particular whether appropriate remedial measures have been or will be taken in the event of any actual or anticipated deficiencies;

(e) provide regular updates to the senior management outlining the current level of risk incurred by each managed AIF and any actual or foreseeable breaches of any risk limits set in accordance with Article 44, so as to ensure that prompt and appropriate action can be taken.

2. The risk management function shall have the necessary authority and access to all relevant information necessary to fulfil the tasks set out in paragraph 1.

Article 40

Risk management policy

1. An AIFM shall establish, implement and maintain an adequate and documented risk management policy which identifies all the relevant risks to which the AIFs it manages are or may be exposed.

2. The risk management policy shall comprise such procedures as are necessary to enable the AIFM to assess for each AIF it manages the exposure of that AIF to market, liquidity and counterparty risks, and the exposure of the AIF to all other relevant risks, including operational risks, which may be material for each AIF it manages.

3. The AIFM shall address at least the following elements in the risk management policy:

(a) the techniques, tools and arrangements that enable it to comply with Article 45;

(b) the techniques, tools and arrangements that enable liquidity risk of the AIF to be assessed and monitored under normal and exceptional liquidity conditions including through the use of regularly conducted stress tests in accordance with Article 48;

(c) the allocation of responsibilities within the AIFM pertaining to risk management;

(d) the limits set in accordance with Article 44 of this Regulation and a justification of how these are aligned with the risk profile of the AIF disclosed to investors in accordance with Article 23(4)(c) of Directive 2011/61/EU;

(e) the terms, contents, frequency and addressees of reporting by the permanent risk management function referred to in Article 39.

4. The risk management policy shall include a description of the safeguards referred to in Article 43, in particular:

(a) the nature of the potential conflicts of interest;

(b) the remedial measures put in place;

(c) the reasons why these measures should be reasonably expected to result in independent performance of the risk management function;

(d) how the AIFM expects to ensure that the safeguards are consistently effective.

5. The risk management policy referred to in paragraph 1 shall be appropriate to the nature, scale and complexity of the business of the AIFM and of the AIF it manages.

Article 41

Assessment, monitoring and review of the risk management systems

1. AIFMs shall assess, monitor and periodically, at least once a year, review:

(a) the adequacy and effectiveness of the risk management policy and of the arrangements, processes and techniques referred to in Article 45;

(b) the degree of compliance by the AIFM with the risk management policy and with the arrangements, processes and techniques referred to in Article 45;

(c) the adequacy and effectiveness of measures taken to address any deficiencies in the performance of the risk management process;

(d) the performance of the risk management function;

(e) the adequacy and effectiveness of measures aiming to ensure the functional and hierarchical separation of the risk management function in accordance with Article 42.

The frequency of the periodic review referred to in the first subparagraph shall be decided by the senior management in accordance with the principle of proportionality given the nature, scale and complexity of the AIFM's business and the AIF it manages.

2. In addition to the periodic review referred to in paragraph 1, the risk management systems shall be reviewed where:

(a) material changes are made to the risk management policies and procedures and to the arrangements, processes and techniques referred to in Article 45;

(b) internal or external events indicate that an additional review is required;

(c) material changes are made to the investment strategy and objectives of an AIF that the AIFM manages.

3. The AIFM shall update the risk management systems on the basis of the outcome of the review referred to in paragraphs 1 and 2.

4. The AIFM shall notify the competent authority of its home Member State of any material changes to the risk management policy and of the arrangements, processes and techniques referred to in Article 45.

Article 42

Functional and hierarchical separation of the risk management function

1. The risk management function shall be considered as functionally and hierarchically separated from the operating units, including the portfolio management function, only where all the following conditions are satisfied:

(a) persons engaged in the performance of the risk management function are not supervised by those responsible for the performance of the operating units, including the portfolio management function, of the AIFM;

(b) persons engaged in the performance of the risk management function are not engaged in the performance of activities within the operating units, including the portfolio management function;

(c) persons engaged in the performance of the risk management function are compensated in accordance with the achievement of the objectives linked to that function, independently of the performance of the operating units, including the portfolio management function;

(d) the remuneration of senior officers in the risk management function is directly overseen by the remuneration committee, where such a committee has been established.

2. The functional and hierarchical separation of the risk management function in accordance with paragraph 1 shall be ensured throughout the whole hierarchical structure of the AIFM, up to its governing body. It shall be reviewed by the governing body and, where it exists, the supervisory function of the AIFM.

3. The competent authorities of the home Member State of the AIFM shall review the way in which the AIFM has applied paragraphs 1 and 2 on the basis of the criteria laid down in the second subparagraph of Article 15(1) of Directive 2011/61/EU.

Article 43

Safeguards against conflicts of interest

1. The safeguards against conflicts of interest referred to in Article 15(1) of Directive 2011/61/EU shall ensure, at least, that:

(a) decisions taken by the risk management function are based on reliable data, which are subject to an appropriate degree of control by the risk management function;

(b) the remuneration of those engaged in the performance of the risk management function reflects the achievement of the objectives linked to the risk management function, independently of the performance of the business areas in which they are engaged;

(c) the risk management function is subject to an appropriate independent review to ensure that decisions are being arrived at independently;

(d) the risk management function is represented in the governing body or the supervisory function, where it has been established, at least with the same authority as the portfolio management function;

(e) any conflicting duties are properly segregated.

2. Where proportionate, taking into account the nature, scale and complexity of the AIFM, the safeguards referred to in paragraph 1 shall also ensure that:

(a) the performance of the risk management function is reviewed regularly by the internal audit function, or, if the latter has not been established, by an external party appointed by the governing body;

(b) where a risk committee has been established, it is appropriately resourced and its non-independent members do not have undue influence over the performance of the risk management function.

3. The governing body of the AIFM and, where it exists, the supervisory function shall establish the safeguards against conflicts of interest laid down in paragraphs 1 and 2, regularly review their effectiveness and take timely remedial action to address any deficiencies.

Article 44

Risk limits

1. An AIFM shall establish and implement quantitative or qualitative risk limits, or both, for each AIF it manages, taking into account all relevant risks. Where only qualitative limits are set, the AIFM shall be able to justify this approach to the competent authority.

2. The qualitative and quantitative risk limits for each AIF shall, at least, cover the following risks:

(a) market risks;

(b) credit risks;

(c) liquidity risks;

(d) counterparty risks;

(e) operational risks.

3. When setting risk limits, the AIFM shall take into account the strategies and assets employed in respect of each AIF it manages as well as the national rules applicable to each of those AIFs. Those risk limits shall be aligned with the risk profile of the AIF as disclosed to investors in accordance with point (c) of Article 23(4) of Directive 2011/61/EU and approved by the governing body.

Article 45

Risk measurement and management

1. AIFMs shall adopt adequate and effective arrangements, processes and techniques in order to:

(a) identify, measure, manage and monitor at any time the risks to which the AIFs under their management are or might be exposed;

(b) ensure compliance with the limits set in accordance with Article 44.

2. The arrangements, processes and techniques referred to in paragraph 1 shall be proportionate to the nature, scale and complexity of the business of the AIFM and of each AIF it manages and shall be consistent with the AIF's risk profile as disclosed to investors in accordance with point (c) of Article 23(4) of Directive 2011/61/EU.

3. For the purposes of paragraph 1, the AIFM shall take the following actions for each AIF it manages:

(a) put in place such risk measurement arrangements, processes and techniques as are necessary to ensure that the risks of positions taken and their contribution to the overall risk profile are accurately measured on the basis of sound and reliable data and that the risk measurement arrangements, processes and techniques are adequately documented;

(b) conduct periodic back-tests in order to review the validity of risk measurement arrangements which include model-based forecasts and estimates;

(c) conduct, periodic appropriate stress tests and scenario analyses to address risks arising from potential changes in market conditions that might adversely impact the AIF;

(d) ensure that the current level of risk complies with the risk limits set in accordance with Article 44;

(e) establish, implement and maintain adequate procedures that, in the event of actual or anticipated breaches of the risk limits of the AIF, result in timely remedial actions in the best interest of investors;

(f) ensure that there are appropriate liquidity management systems and procedures for each AIF in line with the requirements laid down in Article 46.

SECTION 4

Liquidity management

(Article 16 of Directive 2011/61/EU)

Article 46

Liquidity management system and procedures

AIFMs shall be able to demonstrate to the competent authorities of their home Member State that an appropriate liquidity management system and effective procedures referred to in Article 16(1) of Directive 2011/61/EU are in place taking into account the investment strategy, the liquidity profile and the redemption policy of each AIF.

Article 47

Monitoring and managing liquidity risk

1. The liquidity management system and procedures referred to in Article 46 shall at least, ensure that:

(a) the AIFM maintains a level of liquidity in the AIF appropriate to its underlying obligations, based on an assessment of the relative liquidity of the AIF's assets in the market, taking account of the time required for liquidation and the price or value at which those assets can be liquidated, and their sensitivity to other market risks or factors;

(b) the AIFM monitors the liquidity profile of the AIF's portfolio of assets, having regard to the marginal contribution of individual assets which may have a material impact on liquidity, and the material liabilities and commitments, contingent or otherwise, which the AIF may have in relation to its underlying obligations. For these purposes the AIFM shall take into account the profile of the investor base of the AIF, including the type of investors, the relative size of investments and the redemption terms to which these investments are subject;

(c) the AIFM, where the AIF invests in other collective investment undertakings, monitors the approach adopted by the managers of those other collective investment undertakings to the management of liquidity, including through conducting periodic reviews to monitor changes to the redemption provisions of the underlying collective investment undertakings in which the AIF invests. Subject to Article 16(1) of Directive 2011/61/EU, this obligation shall not apply where the other collective investment undertakings in which the AIF invests are actively traded on a regulated market within the meaning of point (14) of Article 4(1) of Directive 2004/39/EC or an equivalent third country market;

(d) the AIFM implements and maintains appropriate liquidity measurement arrangements and procedures to assess the quantitative and qualitative risks of positions and of intended investments which have a material impact on the liquidity profile of the portfolio of the AIF's assets to enable their effects on the overall liquidity profile to be appropriately measured. The procedures employed shall ensure that the AIFM has the appropriate knowledge and understanding of the liquidity of the assets in which the AIF has invested or intends to invest including, where applicable, the trading volume and sensitivity of prices and, as the case may be, or spreads of individual assets in normal and exceptional liquidity conditions;

(e) the AIFM considers and puts into effect the tools and arrangements, including special arrangements, necessary to manage the liquidity risk of each AIF under its management. The AIFM shall identify the types of circumstances where these tools and arrangements may be used in both normal and exceptional circumstances, taking into account the fair treatment of all AIF investors in relation to each AIF under management. The AIFM may use such tools and arrangements only in these circumstances and if appropriate disclosures have been made in accordance with Article 108.

2. AIFMs shall document their liquidity management policies and procedures, as referred to in paragraph 1, review them on at least an annual basis and update them for any changes or new arrangements.

3. AIFMs shall include appropriate escalation measures in their liquidity management system and procedures, as referred to in paragraph 1, to address anticipated or actual liquidity shortages or other distressed situations of the AIF.

4. Where the AIFM manages an AIF which is a leveraged closed-ended AIF, point (e) of paragraph 1 shall not apply.

Article 48

Liquidity management limits and stress tests

1. AIFMs shall, where appropriate, considering the nature, scale and complexity of each AIF they manage, implement and maintain adequate limits for the liquidity or illiquidity of the AIF consistent with its underlying obligations and redemption policy and in accordance with the requirements laid down in Article 44 relating to quantitative and qualitative risk limits.

AIFMs shall monitor compliance with those limits and where limits are exceeded or likely to be exceeded, they shall determine the required (or necessary) course of action. In determining appropriate action, AIFMs shall consider the adequacy of the liquidity management policies and procedures, the appropriateness of the liquidity profile of the AIF's assets and the effect of atypical levels of redemption requests.

2. AIFMs shall regularly conduct stress tests, under normal and exceptional liquidity conditions, which enable them to assess the liquidity risk of each AIF under their management. The stress tests shall:

(a) be conducted on the basis of reliable and up-to-date information in quantitative terms or, where this is not appropriate, in qualitative terms;

(b) where appropriate, simulate a shortage of liquidity of the assets in the AIF and atypical redemption requests;

(c) cover market risks and any resulting impact, including on margin calls, collateral requirements or credit lines;

(d) account for valuation sensitivities under stressed conditions;

(e) be conducted at a frequency which is appropriate to the nature of the AIF, taking in to account the investment strategy, liquidity profile, type of investor and redemption policy of the AIF, and at least once a year.

3. AIFMs shall act in the best interest of investors in relation to the outcome of any stress tests.

Article 49

Alignment of investment strategy, liquidity profile and redemption policy

1. For the purposes of Article 16(2) of Directive 2011/61/EU, the investment strategy, liquidity profile and redemption policy of each AIF managed by an AIFM shall be considered to be aligned when investors have the ability to redeem their investments in a manner consistent with the fair treatment of all AIF investors and in accordance with the AIF's redemption policy and its obligations.

2. In assessing the alignment of the investment strategy, liquidity profile and redemption policy the AIFM shall also have regard to the impact that redemptions may have on the underlying prices or spreads of the individual assets of the AIF.

SECTION 5

Investment in securitisation positions

(Article 17 of Directive 2011/61/EU)

Article 50

Definitions

For the purposes of this Section:

(a) 'securitisation' means a securitisation within the meaning of Article 4(36) of Directive 2006/48/EC;

(b) 'securitisation position' means a securitisation position within the meaning of Article 4(40) of Directive 2006/48/EC;

(c) 'sponsor' means a sponsor within the meaning of Article 4(42) of Directive 2006/48/EC;

(d) 'tranche' means a tranche within the meaning of Article 4(39) of Directive 2006/48/EC.

Article 51

Requirements for retained interest

1. AIFMs shall assume exposure to the credit risk of a securitisation on behalf of one or more AIFs it manages only if the originator, sponsor or original lender has explicitly disclosed to the AIFM that it retains, on an ongoing basis, a material net economic interest, which in any event shall not be less than 5 %.

Only any of the following shall qualify as retention of a material net economic interest of not less than 5 %:

(a) retention of no less than 5 % of the nominal value of each of the tranches sold or transferred to the investors;

(b) in the case of securitisations of revolving exposures, retention of the originator's interest of no less than 5 % of the nominal value of the securitised exposures;

(c) retention of randomly selected exposures, equivalent to not less than 5 % of the nominal value of the securitised exposures, where such exposures would otherwise have been securitised in the securitisation, provided that the number of potentially securitised exposures is not less than 100 at origination;

(d) retention of the first loss tranche and, if necessary, other tranches having the same or a more severe risk profile than those transferred or sold to investors and not maturing any earlier than those transferred or sold to investors, so that the retention equals in total not less than 5 % of the nominal value of the securitised exposures;

(e) retention of a first loss exposure of not less than 5 % of every securitised exposure in the securitisation.

Net economic interest shall be measured at the origination and shall be maintained on an ongoing basis. The net economic interest, including retained positions, interest or exposures, shall not be subject to any credit risk mitigation or any short positions or any other hedge and shall not be sold. The net economic interest shall be determined by the notional value for off-balance sheet items.

There shall be no multiple applications of the retention requirements for any given securitisation.

2. Paragraph 1 shall not apply where the securitised exposures are claims or contingent claims on or fully, unconditionally and irrevocably guaranteed by the institutions listed in the first subparagraph of Article 122a(3) of Directive 2006/48/EC, and shall not apply to those transactions listed in the second subparagraph of Article 122a(3) of Directive 2006/48/EC.

Article 52

Qualitative requirements concerning sponsors and originators

Prior to an AIFM assuming exposure to the credit risk of a securitisation on behalf of one or more AIFs, it shall ensure that the sponsor and originator:

(a) grant credit based on sound and well-defined criteria and clearly establish the process for approving, amending, renewing and re-financing loans to exposures to be securitised as they apply to exposures they hold;

(b) have in place and operate effective systems to manage the ongoing administration and monitoring of their credit risk-bearing portfolios and exposures, including for identifying and managing problem loans and for making adequate value adjustments and provisions;

(c) adequately diversify each credit portfolio based on the target market and overall credit strategy;

(d) have a written policy on credit risk that includes their risk tolerance limits and provisioning policy and describes how it measures, monitors and controls that risk;

(e) grant readily available access to all materially relevant data on the credit quality and performance of the individual underlying exposures, cash flows and collateral supporting a securitisation exposure and such information that is necessary to conduct comprehensive and well informed stress tests on the cash flows and collateral values supporting the underlying exposures. For that purpose, materially relevant data shall be determined as at the date of the securitisation and where appropriate due to the nature of the securitisation thereafter;

(f) grant readily available access to all other relevant data necessary for the AIFM to comply with the requirements laid down in Article 53;

(g) disclose the level of their retained net economic interest as referred to in Article 51, as well as any matters that could undermine the maintenance of the minimum required net economic interest as referred to in that Article.

Article 53

Qualitative requirements concerning AIFMs exposed to securitisations

1. Before becoming exposed to the credit risk of a securitisation on behalf of one or more AIFs, and as appropriate thereafter, AIFMs shall be able to demonstrate to the competent authorities for each of their individual securitisation positions that they have a comprehensive and thorough understanding of those positions and have implemented formal policies and procedures appropriate to the risk profile of the relevant AIF's investments in securitised positions for analysing and recording:

(a) information disclosed under Article 51, by originators or sponsors to specify the net economic interest that they maintain, on an ongoing basis, in the securitisation;

(b) the risk characteristics of the individual securitisation position;

(c) the risk characteristics of the exposures underlying the securitisation position;

(d) the reputation and loss experience in earlier securitisations of the originators or sponsors in the relevant exposure classes underlying the securitisation position;

(e) the statements and disclosures made by the originators or sponsors, or their agents or advisors, about their due diligence on the securitised exposures and, where applicable, on the quality of the collateral supporting the securitised exposures;

(f) where applicable, the methodologies and concepts on which the valuation of collateral supporting the securitised exposures is based and the policies adopted by the originator or sponsor to ensure the independence of the valuer;

(g) all the structural features of the securitisation that can materially impact the performance of the institution's securitisation position, such as the contractual waterfall and waterfall related triggers, credit enhancements, liquidity enhancements, market value triggers, and deal-specific definitions of default.

2. Where an AIFM has assumed exposure to a material value of the credit risk of a securitisation on behalf of one or more AIFs, it shall regularly perform stress tests appropriate to such securitisation positions in accordance with point (b) of Article 15(3) of Directive 2011/61/EU. The stress test shall be commensurate with the nature, scale and complexity of the risk inherent in the securitisation positions.

AIFMs shall establish formal monitoring procedures in line with the principles laid down in Article 15 of Directive 2011/61/EU commensurate with the risk profile of the relevant AIF in relation to the credit risk of a securitisation position in order to monitor on an ongoing basis and in a timely manner performance information on the exposures underlying such securitisation positions. Such information shall include (if relevant to the specific type of securitisation and not limited to such types of information further described herein), the exposure type, the percentage of loans more than 30, 60 and 90 days past due, default rates, prepayment rates, loans in foreclosure, collateral type and occupancy, frequency distribution of credit scores or other measures of credit worthiness across underlying exposures, industry and geographical diversification and frequency distribution of loan to value ratios with bandwidths that facilitate adequate sensitivity analysis. Where the underlying exposures are themselves securitisation positions, AIFMs shall have the information set out in this subparagraph not only on the underlying securitisation tranches, such as the issuer name and credit quality, but also on the characteristics and performance of the pools underlying those securitisation tranches.

AIFMs shall apply the same standards of analysis to participations or underwritings in securitisation issues purchased from third parties.

3. For the purposes of appropriate risk and liquidity management, AIFMs assuming exposure to the credit risk of a securitisation on behalf of one or more AIFs shall properly identify, measure, monitor, manage, control and report the risks that arise because of mismatches between the assets and liabilities of the relevant AIF, concentration risk or investment risk arising from these instruments. The AIFM shall ensure that the risk profile of such securitisation positions corresponds to the size, overall portfolio structure, investment strategies and objectives of the relevant AIF as laid down in the AIF rules or instruments of incorporation, prospectus and offering documents.

4. AIFMs shall ensure, in line with the requirements laid down in Article 18 of Directive 2011/61/EU, that there is an adequate degree of internal reporting to the senior management so that senior management is fully aware of any material assumption of exposure to securitisations and that the risks arising from those exposures are adequately managed.

5. AIFMs shall include appropriate information on their exposures to the credit risk of securitisation and their risk management procedures in this area in the reports and disclosures to be submitted in accordance with Articles 22, 23 and 24 of Directive 2011/61/EU.

Article 54

Corrective action

1. AIFMs shall take such corrective action as is in the best interest of the investors in the relevant AIF where they discover, after the assumption of an exposure to a securitisation, that the determination and disclosure of the retained interest did not meet the requirements laid down in this Regulation.

2. AIFMs shall take such corrective action as is in the best interest of the investors in the relevant AIF, where the retained interest becomes less than 5 % at a given moment after the assumption of the exposure and this is not due to the natural payment mechanism of the transaction.

Article 55

Grandfathering clause

Articles 51 to 54 shall apply in relation to new securitisations issued on or after 1 January 2011. Articles 51 to 54 shall, after 31 December 2014, apply in relation to existing securitisations where new underlying exposures are added or substituted after that date.

Article 56

Interpretation

In the absence of specific interpretation given by ESMA or by the Joint Committee of the European Supervisory Authorities, the provisions of this Section shall be interpreted in a consistent manner with the corresponding provisions of Directive 2006/48/EC and with the Guidelines to Article 122a of the Capital Requirements Directive of 31 December 2010 [1] issued by the Committee of European Banking Supervisors and their subsequent amendments.

SECTION 6

Organisational requirements — general principles

(Articles 12 and 18 of Directive 2011/61/EU)

Article 57

General requirements

1. AIFMs shall:

(a) establish, implement and maintain decision-making procedures and an organisational structure which specifies reporting lines and allocates functions and responsibilities clearly and in a documented manner;

(b) ensure that their relevant persons are aware of the procedures to be followed for the proper discharge of their responsibilities;

(c) establish, implement and maintain adequate internal control mechanisms designed to secure compliance with decisions and procedures at all levels of the AIFM;

(d) establish, implement and maintain effective internal reporting and communication of information at all relevant levels of the AIFM and effective information flows with any third party involved;

(e) maintain adequate and orderly records of their business and internal organisation.

AIFMs shall take into account the nature, scale and complexity of their business and the nature and range of services and activities undertaken in the course of that business.

2. AIFMs shall establish, implement and maintain systems and procedures that are adequate to safeguard the security, integrity and confidentiality of information, taking into account the nature of the information in question.

[1] Committee of European Banking Supervisors, Guidelines to Article 122a of the Capital Requirements Directive of 31 December 2010, http://www.eba.europa.eu/cebs/media/Publications/Standards%20and%20Guidelines/2010/Application%20of%20Art.%20122a%20of%20the%20CRD/Guidelines.pdf

3. AIFMs shall establish, implement and maintain an adequate business continuity policy aimed at ensuring, in the event of an interruption to their systems and procedures, the preservation of essential data and functions, and the maintenance of services and activities, or, where that is not possible, the timely recovery of such data and functions and the timely resumption of their services and activities.

4. AIFMs shall establish, implement and maintain accounting policies and procedures and valuation rules that enable them, at the request of the competent authority, to deliver in a timely manner to the competent authority financial reports which reflect a true and fair view of their financial position and which comply with all applicable accounting standards and rules.

5. AIFMs shall implement appropriate policies and procedures to ensure that the redemption policies of the AIF are disclosed to investors, in sufficient detail, before they invest in the AIF and in the event of material changes.

6. AIFMs shall monitor and, on a regular basis, evaluate the adequacy and effectiveness of their systems, internal control mechanisms and arrangements established in accordance with paragraphs 1 to 5, and take appropriate measures to address any deficiencies.

Article 58

Electronic data processing

1. AIFMs shall make appropriate and sufficient arrangements for suitable electronic systems so as to permit the timely and proper recording of each portfolio transaction or subscription or, where relevant, redemption order.

2. AIFMs shall ensure a high standard of security during the electronic data processing and integrity and confidentiality of the recorded information, as appropriate.

Article 59

Accounting procedures

1. AIFMs shall employ accounting policies and procedures as referred to in Article 57(4) so as to ensure the protection of investors. The accounting records shall be kept in such a way that all assets and liabilities of the AIF can be directly identified at all times. If an AIF has different investment compartments, separate accounts shall be maintained for those compartments.

2. AIFMs shall establish, implement and maintain accounting and valuation policies and procedures so as to ensure that the net asset value of each AIF is accurately calculated on the basis of the applicable accounting rules and standards.

Article 60

Control by the governing body, senior management and supervisory function

1. When allocating functions internally, AIFMs shall ensure that the governing body, the senior management and, where it exists, the supervisory function are responsible for the AIFM's compliance with its obligations under Directive 2011/61/EU.

2. An AIFM shall ensure that its senior management:

(a) is responsible for the implementation of the general investment policy for each managed AIF, as defined, where relevant, in the fund rules, the instruments of incorporation, the prospectus or the offering documents;

(b) oversees the approval of the investment strategies for each managed AIF;

(c) is responsible for ensuring that valuation policies and procedures in accordance with Article 19 of Directive 2011/61/EU are established and implemented;

(d) is responsible for ensuring that the AIFM has a permanent and effective compliance function, even if this function is performed by a third party;

(e) ensures and verifies on a periodic basis that the general investment policy, the investment strategies and the risk limits of each managed AIF are properly and effectively implemented and complied with, even if the risk management function is performed by third parties;

(f) approves and reviews on a periodic basis the adequacy of the internal procedures for undertaking investment decisions for each managed AIF, so as to ensure that such decisions are consistent with the approved investment strategies;

(g) approves and reviews on a periodic basis the risk management policy and the arrangements, processes and techniques for implementing that policy, including the risk limit system for each AIF it manages;

(h) is responsible for establishing and applying a remuneration policy in line with Annex II to Directive 2011/61/EU.

3. An AIFM shall also ensure that its senior management and, where appropriate, its governing body or supervisory function:

(a) assess and periodically review the effectiveness of the policies, arrangements and procedures put in place to comply with the obligations laid down in Directive 2011/61/EU;

(b) take appropriate measures to address any deficiencies.

4. An AIFM shall ensure that its senior management receives on a frequent basis, and at least annually, written reports on matters of compliance, internal audit and risk management indicating in particular whether appropriate remedial measures have been taken in the event of any deficiencies.

5. An AIFM shall ensure that its senior management receives on a regular basis reports on the implementation of investment strategies and of the internal procedures for taking investment decisions referred to in points (b) to (e) of paragraph 2.

6. An AIFM shall ensure that the governing body or the supervisory function, if any, receives on a regular basis written reports on the matters referred to in paragraph 4.

Article 61

Permanent compliance function

1. AIFMs shall establish, implement and maintain adequate policies and procedures designed to detect any risk of failure by the AIFM to comply with its obligations under Directive 2011/61/EU, and the associated risks, and put in place adequate measures and procedures designed to minimise such risk and to enable the competent authorities to exercise their powers effectively under that Directive.

The AIFM shall take into account the nature, scale and complexity of its business, and the nature and range of services and activities undertaken in the course of that business.

2. An AIFM shall establish and maintain a permanent and effective compliance function which operates independently and has the following responsibilities:

(a) monitoring and, on a regular basis, evaluating the adequacy and effectiveness of the measures, policies and procedures put in place in accordance with paragraph 1 and the actions taken to address any deficiencies in the AIFM's compliance with its obligations;

(b) advising the relevant persons responsible for carrying out services and activities and assisting them in complying with the AIFM's obligations under Directive 2011/61/EU.

3. In order to enable the compliance function referred to in paragraph 2 to perform its responsibilities properly and independently, the AIFM shall ensure that:

(a) the compliance function has the necessary authority, resources, expertise and access to all relevant information;

(b) a compliance officer is appointed and is responsible for the compliance function and for reporting on a frequent basis, and at least annually, to the senior management on matters of compliance, indicating in particular whether appropriate remedial measures have been taken in the event of any deficiencies;

(c) persons in the compliance function are not involved in the performance of services or activities they monitor;

(d) the method of determining the remuneration of a compliance officer and other persons in the compliance function do not affect their objectivity and are not likely to do so.

However, the AIFM shall not be required to comply with point (c) or (d) of the first subparagraph where it is able to demonstrate that in view of the nature, scale and complexity of its business, and the nature and range of its services and activities, that the requirement is not proportionate and that its compliance function continues to be effective.

Article 62

Permanent internal audit function

1. AIFMs shall, where appropriate and proportionate in view of the nature, scale and complexity of their business and the nature and range of collective portfolio management activities undertaken in the course of that business, establish and maintain an internal audit function which is separate and independent from the other functions and activities of the AIFM.

2. The internal audit function referred to in paragraph 1 shall:

(a) establish, implement and maintain an audit plan to examine and evaluate the adequacy and effectiveness of the AIFM's systems, internal control mechanisms and arrangements;

(b) issue recommendations based on the results of work carried out in accordance with point (a);

(c) verify compliance with the recommendations referred to in point (b);

(d) report internal audit matters.

Article 63

Personal transactions

1. For any relevant person who is involved in activities that may give rise to a conflict of interest, or who has access to inside information within the meaning of Article 1(1) of Directive 2003/6/EC of the European Parliament and of the Council of 28 January 2003 on insider dealing and market manipulation (market abuse) [1] or to other confidential information relating to an AIF or transactions with or for an AIF, an AIFM shall establish, implement and maintain adequate arrangements aimed at preventing such relevant persons from:

(a) entering into a personal transaction in financial instruments or other assets which fulfils one of the following criteria:

(i) the transaction is subject to Article 2(1) of Directive 2003/6/EC;

(ii) the transaction involves the misuse or improper disclosure of confidential information;

(iii) the transaction conflicts or is likely to conflict with an obligation of the AIFM under Directive 2011/61/EU;

(b) advising or inducing, other than in the proper course of his employment or contract for services, any other person to enter into a personal transaction referred to in point (a)(i) and (ii), or that would otherwise constitute a misuse of information relating to pending orders;

(c) disclosing, other than in the normal course of his employment or contract for services and without prejudice to Article 3(a) of Directive 2003/6/EC, any information or opinion to any other person if the relevant person knows, or reasonably ought to know, that as a result of that disclosure that other person would or would be likely to take either of the following steps:

(i) entering into a personal transaction referred to in point (a)(i) and (ii) in financial instruments or other assets or that would otherwise constitute a misuse of information relating to pending orders;

(ii) advising or inducing another person to enter into such a personal transaction.

2. The arrangements referred to in paragraph 1 shall in particular be designed to ensure that:

(a) each relevant person is aware of the restrictions on personal transactions referred to in paragraph 1, and of the measures established by the AIFM in connection with personal transactions and disclosure, pursuant to paragraph 1;

(b) the AIFM is informed promptly of any personal transaction entered into by a relevant person covered by paragraph 1, either by notification of that transaction or by other procedures enabling the AIFM to identify such transactions;

(c) a record is kept of the personal transaction notified to the AIFM or identified by it, including any authorisation or prohibition in connection with such a transaction.

For the purposes of point (b) of the first subparagraph, where certain activities of the AIFM are performed by third parties, the AIFM shall ensure that the entity performing the activity maintains a record of personal transactions entered into by any relevant person covered by paragraph 1 and provides that information to the AIFM promptly on request.

3. Paragraphs 1 and 2 shall not apply to personal transactions:

(a) effected under a discretionary portfolio management service where there is no prior communication in connection with the transaction between the portfolio manager and the relevant person or other person for whose account the transaction is executed;

(b) in UCITS or AIFs that are subject to supervision under the law of a Member State which requires an equivalent level of risk spreading in their assets, where the relevant person and any other person for whose account the transactions are effected are not involved in the management of that undertaking.

4. For the purpose of paragraph 1, a personal transaction shall also include a transaction in a financial instrument or other asset effected on behalf or for the account of:

(a) a relevant person;

(b) any person with whom the relevant person has a family relationship or with whom the relevant person has close links;

(c) a person whose relationship with the relevant person is such that the relevant person has a direct or indirect material interest in the outcome of the trade, other than a fee or commission for the execution of the trade.

[1] OJ L 96, 12.4.2003, p. 16.

Article 64

Recording of portfolio transactions

1. AIFMs shall make without delay for each portfolio transaction relating to AIFs it manages a record of information which is sufficient to reconstruct the details of the order and the executed transaction or of the agreement.

2. With regard to portfolio transactions on an execution venue, the record referred to in paragraph 1 shall include the following information:

(a) the name or other designation of the AIF and of the person acting for the account of the AIF;

(b) the asset;

(c) where relevant, the quantity;

(d) the type of the order or transaction;

(e) the price;

(f) for orders, the date and exact time of the transmission of the order and the name or other designation of the person to whom the order was transmitted, or for transactions, the date and exact time of the decision to deal and the execution of the transaction;

(g) where applicable, the name of the person transmitting the order or executing the transaction;

(h) where applicable, the reasons for the revocation of an order;

(i) for executed transactions the counterparty and execution venue identification.

3. With regard to portfolio transactions by the AIF outside an execution venue, the record referred to in paragraph 1 shall include the following information:

(a) the name or other designation of the AIF;

(b) the legal and other documentation that forms the basis of the portfolio transaction, including in particular the agreement as executed;

(c) the price.

4. For the purposes of paragraphs 2 and 3, an execution venue shall include a systematic internaliser as referred to in point (7) of Article 4(1) of Directive 2004/39/EC, a regulated market as referred to in point (14) of Article 4(1) of that Directive, a multilateral trading facility as referred to in point (15) of Article 4(1) of that Directive, a market maker as referred to in point (8) of Article 4(1) of that Directive or other liquidity provider or an entity that performs a similar function in a third country to the functions performed by any of the foregoing.

Article 65

Recording of subscription and redemption orders

1. AIFMs shall take all reasonable steps to ensure that received AIF subscriptions and, where relevant, redemption orders are recorded without undue delay after receipt of any such order.

2. That record shall include information on the following:

(a) the relevant AIF;

(b) the person giving or transmitting the order;

(c) the person receiving the order;

(d) the date and time of the order;

(e) the terms and means of payment;

(f) the type of the order;

(g) the date of execution of the order;

(h) the number of units or shares or equivalent amounts subscribed or redeemed;

(i) the subscription or, where relevant, redemption price for each unit or share or, where relevant, the amount of capital committed and paid;

(j) the total subscription or redemption value of the units or shares;

(k) the gross value of the order including charges for subscription, or the net amount after charges for redemption.

Information under points (i), (j) and (k) shall be recorded as soon as available.

Article 66

Recordkeeping requirements

1. AIFMs shall ensure that all required records referred to in Articles 64 and 65 are retained for a period of at least five years.

However, competent authorities may require AIFMs to ensure that any or all of those records are retained for a longer period, taking into account the nature of the asset or portfolio transaction, where it is necessary to enable the authority to exercise its supervisory functions under Directive 2011/61/EU.

2. Following the termination of the authorisation of an AIFM, the records are to be retained at least for the outstanding term of the five-year period referred to in paragraph 1. Competent authorities may require retention for a longer period.

Where the AIFM transfers its responsibilities in relation to the AIF to another AIFM, it shall ensure that the records referred to in paragraph 1 are accessible to that AIFM.

3. The records shall be retained on a medium that allows the storage of information in a way accessible for future reference by the competent authorities, and in such a form and manner that:

(a) the competent authorities are able to access them readily and to reconstitute each key stage of the processing of each portfolio transaction;

(b) corrections or other amendments, and the contents of the records prior to such corrections or amendments, may be easily ascertained;

(c) no other manipulation or alteration is possible.

SECTION 7

Valuation

(Article 19 of Directive 2011/61/EU)

Article 67

Policies and procedures for the valuation of the assets of the AIF

1. AIFMs shall establish, maintain, implement and review, for each AIF they manage, written policies and procedures that ensure a sound, transparent, comprehensive and appropriately documented valuation process. The valuation policy and procedures shall cover all material aspects of the valuation process and valuation procedures and controls in respect of the relevant AIF.

Without prejudice to requirements under national law and the AIF rules and instruments of incorporation, the AIFM shall ensure that fair, appropriate and transparent valuation methodologies are applied for the AIFs it manages. The valuation policies shall identify and the procedures shall implement the valuation methodologies used for each type of asset in which the AIF may invest in accordance with applicable national law, the AIF rules and the instruments of incorporation. The AIFM shall not invest in a particular type of asset for the first time unless an appropriate valuation methodology or methodologies have been identified for that specific type of asset.

The policies and procedures setting out valuation methodologies shall include inputs, models and the selection criteria for pricing and market data sources. They shall provide that prices shall be obtained from independent sources whenever possible and appropriate. The selection process of a particular methodology shall include an assessment of the available relevant methodologies, taking into account their sensitivity to changes in variables and how specific strategies determine the relative value of the assets in the portfolio.

2. The valuation policies shall set out the obligations, roles and responsibilities of all parties involved in the valuation process, including the senior management of the AIFM. The procedures shall reflect the organisational structure as set out in the valuation policies.

The valuation policies and procedures shall address at least the following:

(a) the competence and independence of personnel who are effectively carrying out the valuation of assets;

(b) the specific investment strategies of the AIF and the assets the AIF might invest in;

(c) the controls over the selection of valuation inputs, sources and methodologies;

(d) the escalation channels for resolving differences in values for assets;

(e) the valuation of any adjustments related to the size and liquidity of positions, or to changes in the market conditions, as appropriate;

(f) the appropriate time for closing the books for valuation purposes;

(g) the appropriate frequency for valuing assets.

3. Where an external valuer is appointed, the valuation policies and procedures shall set out a process for the exchange of information between the AIFM and the external valuer to ensure that all necessary information required for the purpose of performing the valuation task is provided.

The valuation policies and procedures shall ensure that the AIFM conducts initial and periodic due diligence on third parties that are appointed to perform valuation services.

4. Where the valuation is performed by the AIFM itself, the policies shall include a description of the safeguards for the functionally independent performance of the valuation task in accordance with point (b) of Article 19(4) of Directive 2011/61/EU. Such safeguards shall include measures to prevent or restrain any person from exercising inappropriate influence over the way in which a person carries out valuation activities.

Article 68

Use of models to value assets

1. If a model is used to value the assets of an AIF, the model and its main features shall be explained and justified in the valuation policies and procedures. The reason for the choice of the model, the underlying data, the assumptions used in the model and the rationale for using them, and the limitations of the model-based valuation shall be appropriately documented.

2. The valuation policies and procedures shall ensure that before being used a model is validated by a person with sufficient expertise who has not been involved in the process of building that model. The validation process shall be appropriately documented.

3. The model shall be subject to prior approval by the senior management of the AIFM. Where the model is used by an AIFM that performs the valuation function itself, the approval by the senior management shall be without prejudice to the competent authority's right to require under Article 19(9) of Directive 2011/61/EU that the model be verified by an external valuer or an auditor.

Article 69

Consistent application of valuation policies and procedures

1. An AIFM shall ensure that the valuation policies and procedures and the designated valuation methodologies are applied consistently.

2. The valuation policies and procedures and the designated methodologies shall be applied to all assets within an AIF taking into account the investment strategy, the type of asset and, if applicable, the existence of different external valuers.

3. Where no update is required, the policies and procedures shall be applied consistently over time and valuation sources and rules shall remain consistent over time.

4. The valuation procedures and the designated valuation methodologies shall be applied consistently across all AIFs managed by the same AIFM, taking into account the investment strategies and the types of asset held by the AIFs, and, if applicable, the existence of different external valuers.

Article 70

Periodic review of valuation policies and procedures

1. Valuation policies shall provide for a periodic review of the policies and procedures, including of the valuation methodologies. The review shall be carried out at least annually and before the AIF engages with a new investment strategy or a new type of asset that is not covered by the actual valuation policy.

2. The valuation policies and procedures shall outline how a change to the valuation policy, including a methodology, may be effected and in what circumstances this would be appropriate. Recommendations for changes to the policies and procedures shall be made to the senior management, which shall review and approve any changes.

3. The risk management function referred to in Article 38 shall review and, if needed, provide appropriate support concerning the policies and procedures adopted for the valuation of assets.

Article 71

Review of individual values of assets

1. An AIFM shall ensure that all assets held by the AIF are fairly and appropriately valued. The AIFM shall document by type of asset the way the appropriateness and fairness of the individual values is assessed. The AIFM shall at all times be able to demonstrate that the portfolios of AIFs it manages are properly valued.

2. The valuation policies and procedures shall set out a review process for the individual values of assets, where a material risk of an inappropriate valuation exists, such as in the following cases:

(a) the valuation is based on prices only available from a single counterparty or broker source;

(b) the valuation is based on illiquid exchange prices;

(c) the valuation is influenced by parties related to the AIFM;

(d) the valuation is influenced by other entities that may have a financial interest in the AIF's performance;

(e) the valuation is based on prices supplied by the counterparty who originated an instrument, in particular where the originator is also financing the AIF's position in the instrument;

(f) the valuation is influenced by one or more individuals within the AIFM.

3. The valuation policies and procedures shall describe the review process including sufficient and appropriate checks and controls on the reasonableness of individual values. Reasonableness shall be assessed in terms of the existence of an appropriate degree of objectivity. Such checks and controls shall include at least:

(a) verifying values by a comparison amongst counterparty-sourced pricings and over time;

(b) validating values by comparison of realised prices with recent carrying values;

(c) considering the reputation, consistency and quality of the valuation source;

(d) a comparison with values generated by a third party;

(e) an examination and documentation of exemptions;

(f) highlighting and researching any differences that appear unusual or vary by valuation benchmark established for the type of asset;

(g) testing for stale prices and implied parameters;

(h) a comparison with the prices of any related assets or their hedges;

(i) a review of the inputs used in model-based pricing, in particular of those to which the model's price exhibits significant sensitivity.

4. The valuation policies and procedures shall include appropriate escalation measures to address differences or other problems in the valuation of assets.

Article 72

Calculation of the net asset value per unit or share

1. An AIFM shall ensure that for each AIF it manages the net asset value per unit or share is calculated on the occasion of each issue or subscription or redemption or cancellation of units or shares, but at least once a year.

2. An AIFM shall ensure that the procedures and the methodology for calculating the net asset value per unit or share are fully documented. The calculation procedures and methodologies and their application shall be subject to regular verification by the AIFM, and the documentation shall be amended accordingly.

3. An AIFM shall ensure that remedial procedures are in place in the event of an incorrect calculation of the net asset value.

4. An AIFM shall ensure that the number of units or shares in issue is subject to regular verification, at least as often as the unit or share price is calculated.

Article 73

Professional guarantees

1. External valuers shall provide upon request professional guarantees to demonstrate their ability to perform the valuation function. Professional guarantees to be furnished by external valuers shall be in written form.

2. The professional guarantees shall contain evidence of the external valuer's qualification and capability to perform proper and independent valuation, including, at least, evidence of:

(a) sufficient personnel and technical resources;

(b) adequate procedures safeguarding proper and independent valuation;

(c) adequate knowledge and understanding of the investment strategy of the AIF and of the assets the external valuer is appointed to value;

(d) a sufficiently good reputation and sufficient experience with valuation.

3. Where the external valuer is subject to mandatory professional registration with the competent authority or another entity of the state where it is established, the professional guarantee shall contain the name of this authority or entity, including the relevant contact information. The professional guarantee shall indicate clearly the legal or regulatory provisions or rules of professional conduct to which the external valuer is subject.

Article 74

Frequency of valuation of assets held by open-ended AIFs

1. The valuation of financial instruments held by open-ended AIFs shall take place every time the net asset value per unit or share is calculated pursuant to Article 72(1).

2. The valuation of other assets held by open-ended AIFs shall take place at least once a year, and every time there is evidence that the last determined value is no longer fair or proper.

SECTION 8

Delegation of AIFM functions

(Article 20(1), (2), (4) and (5) of Directive 2011/61/EU)

Article 75

General principles

When delegating the task of carrying out one or more functions on their behalf, AIFMs shall comply, in particular, with the following general principles:

(a) the delegation structure does not allow for the circumvention of the AIFM's responsibilities or liability;

(b) the obligations of the AIFM towards the AIF and its investors are not altered as a result of the delegation;

(c) the conditions with which the AIFM must comply in order to be authorised and carry out activities in accordance with Directive 2011/61/EU are not undermined;

(d) the delegation arrangement takes the form of a written agreement concluded between the AIFM and the delegate;

(e) the AIFM ensures that the delegate carries out the delegated functions effectively and in compliance with applicable law and regulatory requirements and must establish methods and procedures for reviewing on an ongoing basis the services provided by the delegate. The AIFM shall take appropriate action if it appears that the delegate cannot carry out the functions effectively or in compliance with applicable laws and regulatory requirements;

(f) the AIFM supervises effectively the delegated functions and manages the risks associated with the delegation. For this purpose the AIFM shall have at all times the necessary expertise and resources to supervise the delegated functions. The AIFM shall set out in the agreement its right of information, inspection, admittance and access, and its instruction and monitoring rights against the delegate. The AIFM shall also ensure that the delegate properly supervises the performance of the delegated functions, and adequately manages the risks associated with the delegation;

(g) the AIFM ensures that the continuity and quality of the delegated functions or of the delegated task of carrying out functions are maintained also in the event of termination of the delegation either by transferring the delegated functions or the delegated task of carrying out functions to another third party or by performing them itself;

(h) the respective rights and obligations of the AIFM and the delegate are clearly allocated and set out in the agreement. In particular, the AIFM shall contractually ensure its instruction and termination rights, its rights of information, and its right to inspections and access to books and premises. The agreement shall make sure that sub-delegation can take place only with the consent of the AIFM;

(i) where it concerns portfolio management, the delegation is in accordance with the investment policy of the AIF. The delegate shall be instructed by the AIFM how to implement the investment policy and the AIFM shall monitor whether the delegate complies with it on an ongoing basis;

(j) the AIFM ensures that the delegate discloses to the AIFM any development that may have a material impact on the delegate's ability to carry out the delegated functions effectively and in compliance with applicable laws and regulatory requirements;

(k) the AIFM ensures that the delegate protects any confidential information relating to the AIFM, the AIF affected by the delegation and the investors in that AIF;

(l) the AIFM ensures that the delegate establishes, implements and maintains a contingency plan for disaster recovery and periodic testing of backup facilities while taking into account the types of delegated functions.

Article 76

Objective reasons for delegation

1. The AIFM shall provide the competent authorities with a detailed description, explanation and evidence of the objective reasons for delegation. When assessing whether the entire delegation structure is based on objective reasons within the meaning of Article 20(1)(a) of Directive 2011/61/EU the following criteria shall be considered:

(a) optimising of business functions and processes;

(b) cost saving;

(c) expertise of the delegate in administration or in specific markets or investments;

(d) access of the delegate to global trading capabilities.

2. Upon request by the competent authorities, an AIFM shall provide further explanations and provide documents proving that the entire delegation structure is based on objective reasons.

Article 77

Features of the delegate

1. A delegate shall have sufficient resources and shall employ sufficient personnel with the skills, knowledge and expertise necessary for the proper discharge of the tasks delegated to it and have an appropriate organisational structure supporting the performance of the delegated tasks.

2. Persons who effectively conduct the activities delegated by the AIFM shall have sufficient experience, appropriate theoretical knowledge and appropriate practical experience in the relevant functions. Their professional training and the nature of the functions they have performed in the past shall be appropriate for the conduct of the business.

3. Persons who effectively conduct the business of the delegate shall not be deemed of sufficiently good repute if they have any negative records relevant both for the assessment of good repute and for the proper performance of the delegated tasks or if there is other relevant information which affects their good reputation. Such negative records shall include but shall not be limited to criminal offences, judicial proceedings or administrative sanctions relevant for the performance of the delegated tasks. Special attention shall be given to any offences related to financial activities, including but not limited to obligations relating to the prevention of money laundering, dishonesty, fraud or financial crime, bankruptcy or insolvency. Other relevant information shall include information such as that indicating that the person is not trustworthy or honest.

Where the delegate is regulated in respect of its professional services within the Union, factors referred to in the first subparagraph shall be deemed to be satisfied when the relevant supervisory authority has reviewed the criterion of 'good repute' within the authorisation procedure unless there is evidence to the contrary.

Article 78

Delegation of portfolio or risk management

1. This Article shall apply where the delegation of portfolio management or risk management is concerned.

2. The following entities shall be deemed to be authorised or registered for the purpose of asset management and subject to supervision in accordance with point (c) of Article 20(1) of Directive 2011/61/EU:

(a) management companies authorised under Directive 2009/65/EC;

(b) investment firms authorised under Directive 2004/39/EC to perform portfolio management;

(c) credit institutions authorised under Directive 2006/48/EC having the authorisation to perform portfolio management under Directive 2004/39/EC;

(d) external AIFMs authorised under Directive 2011/61/EU;

(e) third country entities authorised or registered for the purpose of asset management and effectively supervised by a competent authority in those countries.

3. Where the delegation is conferred on a third-country undertaking the following conditions shall be fulfilled in accordance with point (d) of Article 20(1) of Directive 2011/61/EU:

(a) a written arrangement shall exist between the competent authorities of the home Member State of the AIFM and the supervisory authorities of the undertaking to which delegation is conferred;

(b) with respect to the undertaking to which delegation is conferred, the arrangement referred to in point (a) allows the competent authorities to:

(i) obtain on request the relevant information necessary to carry out their supervisory tasks as provided for in Directive 2011/61/EU;

(ii) obtain access to the documents relevant for the performance of their supervisory duties maintained in the third country;

(iii) carry out on-site inspections on the premises of the undertaking to which functions were delegated. The practical procedures for on-site inspections shall be detailed in the written arrangement;

(iv) receive as soon as possible information from the supervisory authority in the third country for the purpose of investigating apparent breaches of the requirements of Directive 2011/61/EU and its implementing measures;

(v) cooperate in enforcement in accordance with the national and international law applicable to the supervisory authority of the third country and the EU competent authorities in cases of breach of the requirements of Directive 2011/61/EU and its implementing measures and relevant national law.

Article 79

Effective supervision

A delegation shall be deemed to prevent the effective supervision of the AIFM where:

(a) the AIFM, its auditors and the competent authorities do not have effective access to data related to the delegated functions and to the business premises of the delegate, or the competent authorities are not able to exercise those rights of access;

(b) the delegate does not cooperate with the competent authorities of the AIFM in connection with the delegated functions;

(c) the AIFM does not make available on request to the competent authorities all information necessary to enable authorities to supervise the compliance of the performance of the delegated functions with the requirements of Directive 2011/61/EU and its implementing measures.

Article 80

Conflicts of interest

1. In accordance with point (b) of Article 20(2) of Directive 2011/61/EU, the criteria to assess whether a delegation conflicts with the interests of the AIFM or the investor in the AIF shall at least include:

(a) where the AIFM and the delegate are members of the same group or have any other contractual relationship, the extent to which the delegate controls the AIFM or has the ability to influence its actions;

(b) where the delegate and an investor in the relevant AIF are members of the same group or have any other contractual relationship, the extent to which this investor controls the delegate or has the ability to influence its actions;

(c) the likelihood that the delegate makes a financial gain, or avoids a financial loss, at the expense of the AIF or the investors in the AIF;

(d) the likelihood that the delegate has an interest in the outcome of a service or an activity provided to the AIFM or the AIF;

(e) the likelihood that the delegate has a financial or other incentive to favour the interest of another client over the interests of the AIF or the investors in the AIF;

(f) the likelihood that the delegate receives or will receive from a person other than the AIFM an inducement in relation to the collective portfolio management activities provided to the AIFM and the AIFs it manages in the form of monies, goods or services other than the standard commission or fee for that service.

2. The portfolio or risk management function may be considered to be functionally and hierarchically separated from other potentially conflicting tasks only where the following conditions are satisfied:

(a) persons engaged in portfolio management tasks are not engaged in the performance of potentially conflicting tasks such as controlling tasks;

(b) persons engaged in risk management tasks are not engaged in the performance of potentially conflicting tasks such as operating tasks;

(c) persons engaged in risk management functions are not supervised by those responsible for the performance of operating tasks;

(d) the separation is ensured throughout the whole hierarchical structure of the delegate up to its governing body and is reviewed by the governing body and, where it exists, the supervisory function of the delegate.

3. Potential conflicts of interest shall be deemed properly identified, managed, monitored and disclosed to the investors of the AIF only if:

(a) the AIFM ensures that the delegate takes all reasonable steps to identify, manage and monitor potential conflicts of interest that may arise between itself and the AIFM, the AIF or the investors in the AIF. The AIFM shall ensure that the delegate has procedures in place corresponding to those required under Articles 31 to 34;

(b) the AIFM ensures that the delegate discloses potential conflicts of interest as well as the procedures and measures to be adopted by it in order to manage such conflicts of interest to the AIFM which shall disclose them to the AIF and the investors in the AIF in accordance with Article 36.

Article 81

Consent and notification of sub-delegation

1. A subdelegation shall become effective where the AIFM demonstrates its consent to it in writing.

A general consent given in advance by the AIFM shall not be deemed consent in accordance with point (a) of Article 20(4) of Directive 2011/61/EU.

2. Pursuant to point (b) of Article 20(4) of Directive 2011/61/EU, the notification shall contain details of the delegate, the name of the competent authority where the sub-delegate is authorised or registered, the delegated functions, the AIFs affected by the sub-delegation, a copy of the written consent by the AIFM and the intended effective date of the sub-delegation.

Article 82

Letter-box entity and AIFM no longer considered to be managing an AIF

1. An AIFM shall be deemed a letter-box entity and shall no longer be considered to be the manager of the AIF at least in any of the following situations:

(a) the AIFM no longer retains the necessary expertise and resources to supervise the delegated tasks effectively and manage the risks associated with the delegation;

(b) the AIFM no longer has the power to take decisions in key areas which fall under the responsibility of the senior management or no longer has the power to perform senior management functions in particular in relation to the implementation of the general investment policy and investment strategies;

(c) the AIFM loses its contractual rights to inquire, inspect, have access or give instructions to its delegates or the exercise of such rights becomes impossible in practice;

(d) the AIFM delegates the performance of investment management functions to an extent that exceeds by a substantial margin the investment management functions performed by the AIFM itself. When assessing the extent of delegation, competent authorities shall assess the entire delegation structure taking into account not only the assets managed under delegation but also the following qualitative criteria:

(i) the types of assets the AIF or the AIFM acting on behalf of the AIF is invested in, and the importance of the assets managed under delegation for the risk and return profile of the AIF;

(ii) the importance of the assets under delegation for the achievement of the investment goals of the AIF;

(iii) the geographical and sectoral spread of the AIF's investments;

(iv) the risk profile of the AIF;

(v) the type of investment strategies pursued by the AIF or the AIFM acting on behalf of the AIF;

(vi) the types of tasks delegated in relation to those retained; and

(vii) the configuration of delegates and their sub-delegates, their geographical sphere of operation and their corporate structure, including whether the delegation is conferred on an entity belonging to the same corporate group as the AIFM.

2. The Commission shall monitor, in the light of market developments, the application of this Article. The Commission shall review the situation after two years and shall, if necessary, take appropriate measures to further specify the conditions under which the AIFM shall be deemed to have delegated its functions to the extent that it becomes a letter box entity and can no longer be considered to be manager of the AIF.

3. ESMA may issue guidelines to ensure a consistent assessment of delegation structures across the Union.

CHAPTER IV

DEPOSITARY

SECTION 1

Particulars of the written contract

(Article 21(2) of Directive 2011/61/EU)

Article 83

Contractual particulars

1. A contract by which the depositary is appointed in accordance with Article 21(2) of Directive 2011/61/EU shall be drawn up between the depositary on the one hand and the AIFM and, as the case may be, or the AIF on the other hand and shall include at least the following elements:

(a) a description of the services to be provided by the depositary and the procedures to be adopted for each type of asset in which the AIF may invest and which shall then be entrusted to the depositary;

(b) a description of the way in which the safe-keeping and oversight function is to be performed depending on the types of assets and the geographical regions in which the AIF plans to invest. With respect to the custody duties this description shall include country lists and procedures for adding and, as the case may be, or withdrawing countries from that list. This shall be consistent with the information provided in the AIF rules, instruments of incorporation and offering documents regarding the assets in which the AIF may invest;

(c) a statement that the depositary's liability shall not be affected by any delegation of its custody functions unless it has discharged itself of its liability in accordance with Article 21(13) or (14) of Directive 2011/61/EU;

(d) the period of validity and the conditions for amendment and termination of the contract including the situations which could lead to the termination of the contract and details regarding the termination procedure and, if applicable, the procedures by which the depositary should send all relevant information to its successor;

(e) the confidentiality obligations applicable to the parties in accordance with relevant laws and regulations. These obligations shall not impair the ability of competent authorities to have access to the relevant documents and information;

(f) the means and procedures by which the depositary transmits to the AIFM or the AIF all relevant information that it needs to perform its duties including the exercise of any rights attached to assets, and in order to allow the AIFM and the AIF to have a timely and accurate overview of the accounts of the AIF;

(g) the means and procedures by which the AIFM or the AIF transmits all relevant information or ensures the depositary has access to all the information it needs to fulfil its duties, including the procedures ensuring that the depositary will receive information from other parties appointed by the AIF or the AIFM;

(h) information on whether or not the depositary, or a third party to whom safe-keeping functions are delegated in accordance with Article 21(11) of Directive 2011/61/EU may re-use the assets it has been entrusted with and, if any, the conditions attached to any such re-use;

(i) the procedures to be followed when an amendment to the AIF rules, instruments of incorporation or offering documents is being considered, detailing the situations in which the depositary is to be informed, or where the prior agreement of the depositary is needed to proceed with the amendment;

(j) all necessary information that needs to be exchanged between the AIF, the AIFM, a third party acting on behalf of the AIF or the AIFM, on the one hand, and the depositary, on the other hand, related to the sale, subscription, redemption, issue, cancellation and re-purchase of units or shares of the AIF;

(k) all necessary information that needs to be exchanged between the AIF, the AIFM, a third party acting on behalf of the AIF or the AIFM and the depositary related to the performance of the depositary's oversight and control function;

(l) where the parties to the contract envisage appointing third parties to carry out parts of their respective duties, a commitment to provide, on a regular basis, details of any third party appointed and, upon request, information on the criteria used to select the third party and the steps envisaged to monitor the activities carried out by the selected third party;

(m) information on the tasks and responsibilities of the parties to the contract in respect of obligations relating to the prevention of money laundering and the financing of terrorism;

(n) information on all cash accounts opened in the name of the AIF or in the name of the AIFM acting on behalf of the AIF and the procedures ensuring that the depositary will be informed when any new account is opened in the name of the AIF or in the name of the AIFM acting on behalf of the AIF;

(o) details regarding the depositary's escalation procedures, including the identification of the persons to be contacted within the AIF and, as the case may be, or the AIFM by the depositary when it launches such a procedure;

(p) a commitment by the depositary to notify the AIFM when it becomes aware that the segregation of assets is not, or is no longer sufficient to ensure protection from insolvency of a third party, to whom safe-keeping functions are delegated in accordance with Article 21(11) of Directive 2011/61/EU in a specific jurisdiction;

(q) the procedures ensuring that the depositary, in respect of its duties, has the ability to enquire into the conduct of the AIFM and, as the case may be, or the AIF and to assess the quality of information transmitted including by way of having access to the books of the AIF and, as the case may be, or AIFM or by way of on-site visits;

(r) the procedures ensuring that the AIFM and, as the case may be, or the AIF can review the performance of the depositary in respect of the depositary's contractual obligations.

2. The details of the means and procedures set out in points (a) to (r) shall be described in the contract appointing the depositary or any subsequent amendment to the contract.

3. The contract appointing the depositary or the subsequent amendment to the contract referred to in paragraph 2 shall be done in writing.

4. The parties may agree to transmit all or part of the information that flows between them electronically provided that proper recording of such information is ensured.

5. Unless otherwise provided by national law, there shall be no obligation to enter into a specific written agreement for each AIF; it shall be possible for the AIFM and the depositary to enter into a framework agreement listing the AIFs managed by that AIFM to which the agreement applies.

6. The national law applicable to the contract appointing the depositary and any subsequent agreement shall be specified.

SECTION 2

General criteria for assessing the prudential regulation and supervision applicable to depositaries in third countries

(Article 21(6)(b) of Directive 2011/61/EU)

Article 84

Criteria for assessing prudential regulation and supervision applicable to a depositary in a third country

For the purposes of point (b) of Article 21(6) of Directive 2011/61/EU, the effectiveness of prudential regulation and supervision applicable to a depositary in a third country whether it has the same effect as that provided for under Union law and its effective enforcement shall be assessed against the following criteria:

(a) the depositary is subject to authorisation and ongoing supervision by a public competent authority with adequate resources to fulfil its tasks;

(b) the law of the third country lay down criteria for authorisation as a depositary that have the same effect as those laid down for access to the business of credit institutions or investment firms within the Union;

(c) the capital requirements imposed on the depositary in the third country have the same effect as those applicable in the Union depending on whether the depositary is of the same nature as an Union credit institution or investment firm;

(d) the operating conditions applicable to a depositary in the third country have the same effect as those laid down for credit institutions or investment firms within the Union depending on the nature of the depositary;

(e) the requirements regarding the performance of the specific duties as AIF depositary established in the law of the third country have the same effect as those provided for in Article 21(7) to (15) of Directive 2011/61/EU and its implementing measures and the relevant national law;

(f) the law of the third country provides for the application of sufficiently dissuasive enforcement actions in the event of breach by the depositary of the requirements and conditions referred to points (a) to (e).

SECTION 3

Depositary functions, due diligence duties and segregation obligation

(Articles 21(7)-(9) and 21(11)(c) and (d)(iii) of Directive 2011/61/EU)

Article 85

Cash monitoring — general requirements

1. Where a cash account is maintained or opened at an entity referred to in Article 21(7) of Directive 2011/61/EU in the name of the AIF, in the name of the AIFM acting on behalf of the AIF or in the name of the depositary acting on behalf of the AIF, an AIFM shall ensure that the depositary is provided, upon commencement of its duties and on an ongoing basis, with all relevant information it needs to comply with its obligations.

2. In order to have access to all information regarding the AIF's cash accounts and have a clear overview of all the AIF's cash flows, a depositary shall at least:

(a) be informed, upon its appointment, of all existing cash accounts opened in the name of the AIF, or in the name of the AIFM acting on behalf of the AIF;

(b) be informed at the opening of any new cash account by the AIF or by the AIFM acting on behalf of the AIF;

(c) be provided with all information related to the cash accounts opened at a third party entity, directly by those third parties.

Article 86

Monitoring of the AIF's cash flows

A depositary shall ensure effective and proper monitoring of the AIF's cash flows and in particular it shall at least:

(a) ensure that all cash of the AIF is booked in accounts opened with entities referred to in points (a), (b) and (c) of Article 18(1) of Directive 2006/73/EC in the relevant markets where cash accounts are required for the purposes of the AIF's operations and which are subject to prudential regulation and supervision that has the same effect as Union law, is effectively enforced and is in accordance with the principles laid down in Article 16 of Directive 2006/73/EC;

(b) implement effective and proper procedures to reconcile all cash flow movements and perform such reconciliations on a daily basis or, in case of infrequent cash movements, when such cash flow movements occur;

(c) implement appropriate procedures to identify at the close of business day significant cash flows and in particular those which could be inconsistent with the AIF's operations;

(d) review periodically the adequacy of those procedures including through a full review of the reconciliation process at least once a year and ensuring that the cash accounts opened in the name of the AIF, in the name of the AIFM acting on behalf of the AIF or in the name of the depositary acting on behalf of the AIF are included in the reconciliation process;

(e) monitor on an ongoing basis the outcomes of the reconciliations and actions taken as a result of any discrepancies identified by the reconciliation procedures and notify the AIFM if an irregularity has not been rectified without undue delay and also the competent authorities if the situation cannot be clarified and, as the case may be, or corrected;

(f) check the consistency of its own records of cash positions with those of the AIFM. The AIFM shall ensure that all instructions and information related to a cash account opened with a third party are sent to the depositary, so that the depositary is able to perform its own reconciliation procedure.

Article 87

Duties regarding subscriptions

An AIFM shall ensure that the depositary is provided with information about payments made by or on behalf of investors upon the subscription of units or shares of an AIF at the close of each business day when the AIFM, the AIF or a party acting on behalf of it, such as a transfer agent receives such payments or an order from the investor. The AIFM shall ensure that the depositary receives all other relevant information it needs to make sure that the payments are then booked in cash accounts opened in the name of the AIF or in the name of the AIFM acting on behalf of the AIF or in the name of the depositary in accordance with the provisions of Article 21(7) of Directive 2011/61/EU.

Article 88

Financial instruments to be held in custody

1. Financial instruments belonging to the AIF or to the AIFM acting on behalf of the AIF which are not able to be physically delivered to the depositary shall be included in the scope of the custody duties of the depositary where all of the following requirements are met:

(a) they are transferable securities including those which embed derivatives as referred to in the last subparagraph of Article 51(3) of Directive 2009/65/EC and Article 10 of Commission Directive 2007/16/EC [1], money market instruments or units of collective investment undertakings;

(b) they are capable of being registered or held in an account directly or indirectly in the name of the depositary.

2. Financial instruments which, in accordance with applicable national law, are only directly registered in the name of the AIF with the issuer itself or its agent, such as a registrar or a transfer agent, shall not be held in custody.

3. Financial instruments belonging to the AIF or the AIFM acting on behalf of the AIF which are able to be physically delivered to the depositary shall always be included in the scope of the custody duties of the depositary.

Article 89

Safekeeping duties with regard to assets held in custody

1. In order to comply with the obligations laid down in point (a) of Article 21(8) of Directive 2011/61/EU with respect to financial instruments to be held in custody, a depositary shall ensure at least that:

(a) the financial instruments are properly registered in accordance with Article 21(8)(a)(ii) of Directive 2011/61/EU;

(b) records and segregated accounts are maintained in a way that ensures their accuracy, and in particular record the correspondence with the financial instruments and cash held for AIFs;

(c) reconciliations are conducted on a regular basis between the depositary's internal accounts and records and those of any third party to whom custody functions are delegated in accordance with Article 21(11) of Directive 2011/61/EU;

(d) due care is exercised in relation to the financial instruments held in custody in order to ensure a high standard of investor protection;

(e) all relevant custody risks throughout the custody chain are assessed and monitored and the AIFM is informed of any material risk identified;

(f) adequate organisational arrangements are introduced to minimise the risk of loss or diminution of the financial instruments, or of rights in connection with those financial instruments as a result of fraud, poor administration, inadequate registering or negligence;

(g) the AIF's ownership right or the ownership right of the AIFM acting on behalf of the AIF over the assets is verified.

2. Where a depositary has delegated its custody functions to a third party in accordance with Article 21(11) of Directive 2011/61/EU, it shall remain subject to the requirements of points (b) to (e) of paragraph 1 of this Article. It shall also ensure that the third party complies with the requirements of points (b) to (g) of paragraph 1 of this Article and the segregation obligations laid down in Article 99.

[1] OJ L 79, 20.3.2007, p. 11.

3. A depositary's safe-keeping duties as referred to in paragraphs 1 and 2 shall apply on a look-through basis to underlying assets held by financial and, as the case may be, or legal structures controlled directly or indirectly by the AIF or the AIFM acting on behalf of the AIF.

The requirement referred to in the first subparagraph shall not apply to fund of funds structures or master-feeder structures where the underlying funds have a depositary which keeps in custody the assets of these funds.

Article 90

Safekeeping duties regarding ownership verification and record keeping

1. An AIFM shall provide the depositary, upon commencement of its duties and on an ongoing basis, with all relevant information the depositary needs in order to comply with its obligations pursuant to point (b) of Article 21(8) of Directive 2011/61/EU, and ensure that the depositary is provided with all relevant information by third parties.

2. In order to comply with the obligations referred to in point (b) of Article 21(8) of Directive 2011/61/EU, a depositary shall at least:

(a) have access without undue delay to all relevant information it needs in order to perform its ownership verification and record-keeping duties, including relevant information to be provided to the depositary by third parties;

(b) possess sufficient and reliable information for it to be satisfied of the AIF's ownership right or of the ownership right of the AIFM acting on behalf of the AIF over the assets;

(c) maintain a record of those assets for which it is satisfied that the AIF or the AIFM acting on behalf of the AIF holds the ownership. In order to comply with this obligation, the depositary shall:

(i) register in its record, in the name of the AIF, assets, including their respective notional amounts, for which it is satisfied that the AIF or the AIFM acting on behalf of the AIF holds the ownership;

(ii) be able to provide at any time a comprehensive and up-to-date inventory of the AIF's assets, including their respective notional amounts.

For the purpose of point (c)(ii) of paragraph 2, the depositary shall ensure that there are procedures in place so that registered assets cannot be assigned, transferred, exchanged or delivered without the depositary or its delegate having been informed of such transactions and the depositary shall have access without undue delay to documentary evidence of each transaction and position from the relevant third party. The AIFM shall ensure that the relevant third party provides the depositary without undue delay with certificates or other documentary evidence every time there is a sale or acquisition of assets or a corporate action resulting in the issue of financial instruments and at least once a year.

3. In any event, a depositary shall ensure that the AIFM has and implements appropriate procedures to verify that the assets acquired by the AIF it manages are appropriately registered in the name of the AIF or in the name of the AIFM acting on behalf of the AIF, and to check the consistency between the positions in the AIFMs records and the assets for which the depositary is satisfied that the AIF or the AIFM acting on behalf of the AIF holds the ownership. The AIFM shall ensure that all instructions and relevant information related to the AIF's assets are sent to the depositary, so that the depositary is able to perform its own verification or reconciliation procedure.

4. A depositary shall set up and implement an escalation procedure for situations where an anomaly is detected including notification of the AIFM and of the competent authorities if the situation cannot be clarified and, as the case may be, or corrected.

5. A depositary's safe-keeping duties referred to in paragraphs 1 to 4 shall apply on a look-through basis to underlying assets held by financial and, as the case may be, or legal structures established by the AIF or by the AIFM acting on behalf of the AIF for the purposes of investing in the underlying assets and which are controlled directly or indirectly by the AIF or by the AIFM acting on behalf of the AIF.

The requirement referred to in the first subparagraph shall not apply to fund of funds structures and master-feeder structures where the underlying funds have a depositary which provides ownership verification and record-keeping functions for this fund's assets.

Article 91

Reporting obligations for prime brokers

1. Where a prime broker has been appointed, the AIFM shall ensure that from the date of that appointment an agreement is in place pursuant to which the prime broker is required to make available to the depositary in particular a statement in a durable medium which contains the following information:

(a) the values of the items listed in paragraph 3 at the close of each business day;

(b) details of any other matters necessary to ensure that the depositary of the AIF has up-to-date and accurate information about the value of assets the safekeeping of which has been delegated in accordance with Article 21(11) of Directive 2011/61/EU.

2. The statement referred to in paragraph 1 shall be made available to the depositary of the AIF no later than the close of the next business day to which it relates.

3. The items referred to in point (a) of paragraph 1 shall include:

(a) the total value of assets held by the prime broker for the AIF, where safe-keeping functions are delegated in accordance with Article 21(11) of Directive 2011/61/EU. The value of each of the following:

(i) cash loans made to the AIF and accrued interest;

(ii) securities to be redelivered by the AIF under open short positions entered into on behalf of the AIF;

(iii) current settlement amounts to be paid by the AIF under any futures contracts;

(iv) short sale cash proceeds held by the prime broker in respect of short positions entered into on behalf of the AIF;

(v) cash margins held by the prime broker in respect of open futures contracts entered into on behalf of the AIF. This obligation is in addition to the obligations under Articles 87 and 88;

(vi) mark-to-market close-out exposures of any OTC transaction entered into on behalf of the AIF;

(vii) total secured obligations of the AIF against the prime broker; and

(viii) all other assets relating to the AIF;

(b) the value of other assets referred to in point (b) of Article 21(8) of Directive 2011/61/EU held as collateral by the prime broker in respect of secured transactions entered into under a prime brokerage agreement;

(c) the value of the assets where the prime broker has exercised a right of use in respect of the AIF's assets;

(d) a list of all the institutions at which the prime broker holds or may hold cash of the AIF in an account opened in the name of the AIF or in the name of the AIFM acting on behalf of the AIF in accordance with Article 21(7) of Directive 2011/61/EU.

Article 92

Oversight duties — general requirements

1. At the time of its appointment, the depositary shall assess the risks associated with the nature, scale and complexity of the AIF's strategy and the AIFM's organisation in order to devise oversight procedures which are appropriate to the AIF and the assets in which it invests and which are then implemented and applied. Such procedures shall be regularly updated.

2. In performing its oversight duties under Article 21(9) of Directive 2011/61/EU, a depositary shall perform *ex-post* controls and verifications of processes and procedures that are under the responsibility of the AIFM, the AIF or an appointed third party. The depositary shall in all circumstances ensure that an appropriate verification and reconciliation procedure exists which is implemented and applied and frequently reviewed. The AIFM shall ensure that all instructions related to the AIF's assets and operations are sent to the depositary, so that the depositary is able to perform its own verification or reconciliation procedure.

3. A depositary shall establish a clear and comprehensive escalation procedure to deal with situations where potential irregularities are detected in the course of its oversight duties, the details of which shall be made available to the competent authorities of the AIFM upon request.

4. An AIFM shall provide the depositary, upon commencement of its duties and on an ongoing basis, with all relevant information it needs in order to comply with its obligations pursuant to Article 21(9) of Directive 2011/61/EU including information to be provided to the depositary by third parties. The AIFM shall particularly ensure that the depositary is able to have access to the books and perform on-site visits on premises of the AIFM and of those of any service provider appointed by the AIF or the AIFM, such as administrators or external valuers and, as the case may be, or to review reports and statements of recognised external certifications by qualified independent auditors or other experts in order to ensure the adequacy and relevance of the procedures in place.

Article 93

Duties regarding subscription and redemptions

In order to comply with point (a) of Article 21(9) of Directive 2011/61/EU the depositary shall meet the following requirements:

(1) The depositary shall ensure that the AIF, the AIFM or the designated entity has established, implements and applies an appropriate and consistent procedure to:

(i) reconcile the subscription orders with the subscription proceeds, and the number of units or shares issued with the subscription proceeds received by the AIF;

(ii) reconcile the redemption orders with the redemptions paid, and the number of units or shares cancelled with the redemptions paid by the AIF;

(iii) verify on a regular basis that the reconciliation procedure is appropriate.

For the purpose of points (i), (ii) and (iii), the depositary shall in particular regularly check the consistency between the total number of units or shares in the AIF's accounts and the total number of outstanding shares or units that appear in the AIF's register.

(2) A depositary shall ensure and regularly check that the procedures regarding the sale, issue, repurchase, redemption and cancellation of shares or units of the AIF comply with the applicable national law and with the AIF rules or instruments of incorporation and verify that these procedures are effectively implemented.

(3) The frequency of the depositary's checks shall be consistent with the frequency of subscriptions and redemptions.

Article 94

Duties regarding the valuation of shares/units

1. In order to comply with point (b) of Article 21(9) of Directive 2011/61/EU the depositary shall:

(a) verify on an ongoing basis that appropriate and consistent procedures are established and applied for the valuation of the assets of the AIF in compliance with Article 19 of Directive 2011/61/EU and its implementing measures and with the AIF rules and instruments of incorporation; and

(b) ensure that the valuation policies and procedures are effectively implemented and periodically reviewed.

2. A depositary's procedures shall be conducted at a frequency consistent with the frequency of the AIF's valuation policy as defined in Article 19 of Directive 2011/61/EU and its implementing measures.

3. Where a depositary considers that the calculation of the value of the shares or units of the AIF has not been performed in compliance with applicable law or the AIF rules or with Article 19 of Directive 2011/61/EU, it shall notify the AIFM and, as the case may be, or the AIF and ensure that timely remedial action is taken in the best interest of the investors in the AIF.

4. Where an external valuer has been appointed, a depositary shall check that the external valuer's appointment is in accordance with Article 19 of Directive 2011/61/EU and its implementing measures.

Article 95

Duties regarding the carrying out of the AIFM's instructions

In order to comply with point (c) of Article 21(9) of Directive 2011/61/EU the depositary shall at least:

(a) set up and implement appropriate procedures to verify that the AIF and AIFM comply with applicable laws and regulations and with the AIF's rules and instruments of incorporation. In particular, the depositary shall monitor the AIF's compliance with investment restrictions and leverage limits set in the AIF's offering documents. Those procedures shall be proportionate to the nature, scale and complexity of the AIF;

(b) set up and implement an escalation procedure where the AIF has breached one of the limits or restrictions referred to in point (a).

Article 96

Duties regarding the timely settlement of transactions

1. In order to comply with point (d) of Article 21(9)(of Directive 2011/61/EU the depositary shall set up a procedure to detect any situation where a consideration related to the operations involving the assets of the AIF or of the AIFM acting on behalf of the AIF is not remitted to the AIF within the usual time limits, notify the AIFM and, where the situation has not been remedied, request the restitution of the financial instruments from the counterparty where possible.

2. Where transactions do not take place on a regulated market, the usual time limits shall be assessed with regard to the conditions attached to the transactions (OTC derivative contracts or investments in real estate assets or in privately held companies).

Article 97

Duties related to the AIF's income distribution

1. In order to comply with point (e) of Article 21(9)(of Directive 2011/61/EU the depositary shall:

(a) ensure that the net income calculation, once declared by the AIFM, is applied in accordance with the AIF rules, instruments of incorporation and applicable national law;

(b) ensure that appropriate measures are taken where the AIF's auditors have expressed reserves on the annual financial statements. The AIF or the AIFM acting on behalf of the AIF shall provide the depositary with all information on reserves expressed on the financial statements; and

(c) check the completeness and accuracy of dividend payments, once they are declared by the AIFM, and, where relevant, of the carried interest.

2. Where a depositary considers that the income calculation has not been performed in compliance with applicable law or with the AIF rules or instruments of incorporation, it shall notify the AIFM and, as the case may be, or the AIF and ensure that timely remedial action has been taken in the best interest of the AIF's investors.

Article 98

Due diligence

1. In order to fulfil the obligations laid down in point (c) of Article 21(11) of Directive 2011/61/EU a depositary shall implement and apply an appropriate documented due diligence procedure for the selection and ongoing monitoring of the delegate. That procedure shall be reviewed regularly, at least once a year, and made available upon request to competent authorities.

2. When selecting and appointing a third party, to whom safekeeping functions are delegated in accordance with Article 21(11) of Directive 2011/61/EU, a depositary shall exercise all due skill, care and diligence to ensure that entrusting financial instruments to this third party provides an adequate standard of protection. It shall at least:

(a) assess the regulatory and legal framework, including country risk, custody risk and the enforceability of the third party's contracts. That assessment shall in particular enable the depositary to determine the potential implication of an insolvency of the third party for the assets and rights of the AIF. If a depositary becomes aware that the segregation of assets is not sufficient to ensure protection from insolvency because of the law of the country where the third party is located, it shall immediately inform the AIFM;

(b) assess whether the third party's practice, procedures and internal controls are adequate to ensure that the financial instruments of the AIF or of the AIFM acting on behalf of the AIF are subject to a high standard of care and protection;

(c) assess whether the third party's financial strength and reputation are consistent with the tasks delegated. That assessment shall be based on information provided by the potential third party as well as other data and information, where available;

(d) ensure that the third party has the operational and technological capabilities to perform the delegated custody tasks with a satisfactory degree of protection and security.

3. A depositary shall exercise all due skill, care and diligence in the periodic review and ongoing monitoring to ensure that the third party continues to comply with the criteria provided for in paragraph 1 of this Article and the conditions set out in point (d) of Article 21(11) of Directive 2011/61/EU. To this end the depositary shall at least:

(a) monitor the third party's performance and its compliance with the depositary's standards;

(b) ensure that the third party exercises a high standard of care, prudence and diligence in the performance of its custody tasks and in particular that it effectively segregates the financial instruments in line with the requirements of Article 99;

(c) review the custody risks associated with the decision to entrust the assets to the third party and without undue delay notify the AIF or AIFM of any change in those risks. That assessment shall be based on information provided by the third party and other data and information where available. During market turmoil or when a risk has been identified, the frequency and the scope of the review shall be increased. If the depositary becomes aware that the segregation of assets is no longer sufficient to ensure protection from insolvency because of the law of the country where the third party is located, it shall immediately inform the AIFM.

4. Where the third party further delegates any of the functions delegated to it, the conditions and criteria set out in paragraphs 1, 2 and 3 shall apply *mutatis mutandis*.

5. A depositary shall monitor compliance with Article 21(4) of Directive 2011/61/EU.

6. A depositary shall devise contingency plans for each market in which it appoints a third party in accordance with Article 21(11) of Directive 2011/61/EU to perform safekeeping duties. Such a contingency plan shall include the identification of an alternative provider, if any.

7. A depositary shall take measures, including termination of the contract, which are in the best interest of the AIF and its investors where the delegate no longer complies with the requirements.

Article 99

Segregation obligation

1. Where safekeeping functions have been delegated wholly or partly to a third party, a depositary shall ensure that the third party, to whom safe-keeping functions are delegated pursuant to Article 21(11) of Directive 2011/61/EU, acts in accordance with the segregation obligation laid down in point (iii) of Article 21(11)(d) of Directive 2011/61/EU by verifying that the third party:

(a) keeps such records and accounts as are necessary to enable it at any time and without delay to distinguish assets of the depositary's AIF clients from its own assets, assets of its other clients, assets held by the depositary for its own account and assets held for clients of the depositary which are not AIFs;

(b) maintains records and accounts in a way that ensures their accuracy, and in particular their correspondence to the assets safe-kept for the depositary's clients;

(c) conducts, on a regular basis, reconciliations between its internal accounts and records and those of the third party to whom it has delegated safe-keeping functions in accordance with the third subparagraph of Article 21(11) of Directive 2011/61/EU;

(d) introduces adequate organisational arrangements to minimise the risk of loss or diminution of financial instruments or of rights in connection with those financial instruments as a result of misuse of the financial instruments, fraud, poor administration, inadequate record-keeping or negligence;

(e) Where the third party is an entity referred to in points (a), (b) and (c) of Article 18(1) of Directive 2006/73/EC which is subject to effective prudential regulation and supervision that has the same effect as Union law and is effectively enforced, the depositary shall take the necessary steps to ensure that the AIF's cash is held in an account or accounts in accordance with Article 21(7) of Directive 2011/61/EU.

2. Where a depositary has delegated its custody functions to a third party in accordance with Article 21(11) of Directive 2011/61/EU, the monitoring of the third party's compliance with its segregation obligations shall ensure that the financial instruments belonging to its clients are protected from any insolvency of that third party. If, according to the applicable law, including in particular the law relating to property or insolvency, the requirements laid down in paragraph 1 are not sufficient to achieve that objective, the depositary shall assess what additional arrangements are to be made in order to minimise the risk of loss and maintain an adequate standard of protection.

3. Paragraphs 1, and 2 shall apply *mutatis mutandis* when the third party, to whom safe-keeping functions are delegated in accordance with Article 21(11) of Directive 2011/61/EU, has decided to delegate all or part of its safe-keeping functions to another third party pursuant to the third subparagraph of Article 21(11) of Directive 2011/61/EU.

SECTION 4

Loss of financial instruments, liability discharge and objective reasons

(Article 21(12) and (13) of Directive 2011/61/EU)

Article 100

Loss of a financial instrument held in custody

1. A loss of a financial instrument held in custody within the meaning of Article 21(12) of Directive 2011/61/EU shall be deemed to have taken place when, in relation to a financial instrument held in custody by the depositary or by a third party to whom the custody of financial instruments held in custody has been delegated, any of the following conditions is met:

(a) a stated right of ownership of the AIF is demonstrated not to be valid because it either ceased to exist or never existed;

(b) the AIF has been definitively deprived of its right of ownership over the financial instrument;

(c) the AIF is definitively unable to directly or indirectly dispose of the financial instrument.

2. The ascertainment by the AIFM of the loss of a financial instrument shall follow a documented process readily available to the competent authorities. Once a loss is ascertained, it shall be notified immediately to investors in a durable medium.

3. A financial instrument held in custody shall not be deemed to be lost within the meaning of Article 21(12) of Directive 2011/61/EU where an AIF is definitively deprived of its right of ownership in respect of a particular instrument, but this instrument is substituted by or converted into another financial instrument or instruments.

4. In the event of insolvency of the third party to whom the custody of financial instruments held in custody has been delegated, the loss of a financial instrument held in custody shall be ascertained by the AIFM as soon as one of the conditions listed in paragraph 1 is met with certainty.

There shall be certainty as to whether any of the conditions set out in paragraph 1 is fulfilled at the latest at the end of the insolvency proceedings. The AIFM and the depositary shall monitor closely the insolvency proceedings to determine whether all or some of the financial instruments entrusted to the third party to whom the custody of financial instruments has been delegated are effectively lost.

5. A loss of a financial instrument held in custody shall be ascertained irrespective of whether the conditions listed in paragraph 1 are the result of fraud, negligence or other intentional or non-intentional behaviour.

Article 101

Liability discharge under Article 21(12) of Directive 2011/61/EU

1. A depositary's liability under the second subparagraph of Article 21(12) of Directive 2011/61/EU shall not be triggered provided the depositary can prove that all the following conditions are met:

(a) the event which led to the loss is not the result of any act or omission of the depositary or of a third party to whom the custody of financial instruments held in custody in accordance with point (a) of Article 21(8) of Directive 2011/61/EU has been delegated;

(b) the depositary could not have reasonably prevented the occurrence of the event which led to the loss despite adopting all precautions incumbent on a diligent depositary as reflected in common industry practice;

(c) despite rigorous and comprehensive due diligence, the depositary could not have prevented the loss.

This condition may be deemed to be fulfilled when the depositary has ensured that the depositary and the third party to whom the custody of financial instruments held in custody in accordance with point (a) of Article 21(8) of Directive 2011/61/EU has been delegated have taken all of the following actions:

(i) establishing, implementing, applying and maintaining structures and procedures and insuring expertise that are adequate and proportionate to the nature and complexity of the assets of the AIF in order to identify in a timely manner and monitor on an ongoing basis external events which may result in loss of a financial instrument held in custody;

(ii) assessing on an ongoing basis whether any of the events identified under point (i) presents a significant risk of loss of a financial instrument held in custody;

(iii) informing the AIFM of the significant risks identified and taking appropriate actions, if any, to prevent or mitigate the loss of financial instruments held in custody, where actual or potential external events have been identified which are believed to present a significant risk of loss of a financial instrument held in custody.

2. The requirements referred to in points (a) and (b) of paragraph 1 may be deemed to be fulfilled in the following circumstances:

(a) natural events beyond human control or influence;

(b) the adoption of any law, decree, regulation, decision or order by any government or governmental body, including any court or tribunal, which impacts the financial instruments held in custody;

(c) war, riots or other major upheavals.

3. The requirements referred to in points (a) and (b) of paragraph 1 shall not be deemed to be fulfilled in cases such as an accounting error, operational failure, fraud, failure to apply the segregation requirements at the level of the depositary or a third party to whom the custody of financial instruments held in custody in accordance with point (a) of Article 21(8) of Directive 2011/61/EU has been delegated.

4. This Article shall apply *mutatis mutandis* to the delegate when the depositary has contractually transferred its liability in accordance with Article 21(13) and (14) of Directive 2011/61/EU.

Article 102

Objective reasons for the depositary to contract a discharge of liability

1. The objective reasons for contracting a discharge pursuant to Article 21(13) of Directive 2011/61/EU shall be:

(a) limited to precise and concrete circumstances characterising a given activity;

(b) consistent with the depositary's policies and decisions.

2. The objective reasons shall be established each time the depositary intends to discharge itself of liability.

3. The depositary shall be deemed to have objective reasons for contracting the discharge of its liability in accordance with Article 21(13) of Directive 2011/61/EU when the depositary can demonstrate that it had no other option but to delegate its custody duties to a third party. In particular, this shall be the case where:

(a) the law of a third country requires that certain financial instruments be held in custody by a local entity and local entities exist that satisfy the delegation criteria laid down in Article 21(11) of Directive 2011/61/EU; or

(b) the AIFM insists on maintaining an investment in a particular jurisdiction despite warnings by the depositary as to the increased risk this presents.

CHAPTER V

TRANSPARENCY REQUIREMENTS, LEVERAGE, RULES RELATING TO THIRD COUNTRIES AND EXCHANGE OF INFORMATION ON THE POTENTIAL CONSEQUENCES OF AIFM ACTIVITY

SECTION 1

Annual report, disclosure to investors and reporting to competent authorities

(Article 22(2)(a) to (e) and Articles 23(4) and 24(1)of Directive 2011/61/EU)

Article 103

General principles for the annual report

All information provided in the annual report, including the information specified in this Section, shall be presented in a manner that provides materially relevant, reliable, comparable and clear information. The annual report shall contain the information investors need in relation to particular AIF structures.

Article 104

Content and format of the balance sheet or statement of assets and liabilities and of the income and expenditure account

1. The balance sheet or statement of assets and liabilities shall contain at least the following elements and underlying line items in accordance with point (a) of Article 22(2) of Directive 2011/61/EU:

(a) 'assets' comprising the resources controlled by the AIF as a result of past events and from which future economic benefits are expected to flow to the AIF. Assets shall be sub-classified according to the following line items:

(i) 'investments', including, but not limited to, debt and equity securities, real estate and property and derivatives;

(ii) 'cash and cash equivalents', including, but not limited to, cash-in-hand, demand deposits and qualifying short-term liquid investments;

(iii) 'receivables', including, but not limited to, amounts receivable in relation to dividends and interest, investments sold, amounts due from brokers and 'prepayments', including, but not limited to, amounts paid in advance in relation to expenses of the AIF;

(b) 'liabilities', comprising present obligations of the AIF arising from past events, the settlement of which is expected to result in an outflow from the AIF of resources embodying economic benefits. Liabilities shall be sub-classified according to the following line items:

(i) 'payables', including, but not limited to, amounts payable in relation to the purchase of investments or redemption of units or shares in the AIF and amounts due to brokers and 'accrued expenses', including, but not limited to, liabilities for management fees, advisory fees, performance fees, interest and other expenses incurred in the course of operations of the AIF;

(ii) 'borrowings', including, but not limited to, amounts payable to banks and other counterparties;

(iii) 'other liabilities', including, but not limited to, amounts due to counterparties for collateral on return of securities loaned, deferred income and dividends and distributions payable;

(c) 'net assets', representing the residual interest in the assets of the AIF after deducting all its liabilities.

2. The income and expenditure account shall contain at least the following elements and underlying line items:

(a) 'income', representing any increases in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in net assets other than those relating to contributions from investors. Income shall be sub-classified according to the following line items:

(i) 'investment income', which can be further sub-classified as follows:

— 'dividend income', relating to dividends on equity investments to which the AIF is entitled,

— 'interest income', relating to interest on debt investments and on cash to which the AIF is entitled,

— 'rental income', relating to rental income from property investments to which the AIF is entitled;

(ii) 'realised gains on investments', representing gains on the disposal of investments;

(iii) 'unrealised gains on investments', representing gains on the revaluation of investments; and

(iv) 'other income' including, but not limited to, fee income from securities loaned and from miscellaneous sources.

(b) 'expenses', representing decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrences of liabilities that result in decreases in net assets, other than those relating to distributions to investors. Expenses shall, be sub-classified according to the following line items:

— 'investment advisory or management fees', representing contractual fees due to the advisor or AIFM,

— 'other expenses', including, but not limited to, administration fees, professional fees, custodian fees and interest. Individual items, if material in nature, should be disclosed separately,

— 'realised loss on investments', representing loss on the disposal of investments,

— 'unrealised loss on investments', representing loss on the revaluation of investments;

(c) 'net income or expenditure', representing the excess of income over expenditure or expenditure over income, as applicable.

3. The layout, nomenclature and terminology of line items shall be consistent with the accounting standards applicable to or the rules adopted by the AIF, and shall comply with legislation applicable where the AIF is established. Such line items may be amended or extended to ensure compliance with the above.

4. Additional line items, headings and subtotals shall be presented when such presentation is relevant to the understanding of an AIF's financial position in the balance sheet or statement of assets and liabilities or an AIF's financial performance in the content and format of the income and expenditure account. Where relevant additional information shall be presented in the notes to the financial statements. The purpose of the notes shall be to provide narrative descriptions or disaggregation of items presented in the primary statements and information about items that do not qualify for recognition in these statements.

5. Each material class of similar items shall be presented separately. Individual items, if material, shall be disclosed. Materiality shall be assessed under the requirements of the accounting framework adopted.

6. The presentation and classification of items in the balance sheet or statement of assets and liabilities shall be retained from one reporting or accounting period to the next unless it is apparent that another presentation or classification would be more appropriate, as when a shift in the investment strategy leads to different trading patterns, or because an accounting standard has required a change in presentation.

7. With respect to the content and format of the income and expenditure account set out to in Annex IV, all items of income and expense shall be recognised in a given period in the income and expenditure account unless an accounting standard adopted by the AIF requires otherwise.

Article 105

Report on the activities of the financial year

1. The report on activities of the financial year shall include at least:

(a) an overview of investment activities during the year or period, and an overview of the AIF's portfolio at year-end or period end;

(b) an overview of AIF performance over the year or period;

(c) material changes as defined below in the information listed in Article 23 of Directive 2011/61/EU not already present in the financial statements.

2. The report shall include a fair and balanced review of the activities and performance of the AIF, containing also a description of the principal risks and investment or economic uncertainties that the AIF might face.

3. To the extent necessary for an understanding of the AIF's investment activities or its performance, the analysis shall include both financial and non-financial key performance indicators relevant to that AIF. The information provided in the report shall be consistent with national rules where the AIF is established.

4. The information in the report on the activities of the financial year shall form part of the directors or investment managers report in so far as this is usually presented alongside the financial statements of the AIF.

Article 106

Material changes

1. Any changes in information shall be deemed material within the meaning of point (d) of Article 22(2) of Directive 2011/61/EU if there is a substantial likelihood that a reasonable investor, becoming aware of such information, would reconsider its investment in the AIF, including because such information could impact an investor's ability to exercise its rights in relation to its investment, or otherwise prejudice the interests of one or more investors in the AIF.

2. In order to comply with point (d) of Article 22(2) of Directive 2011/61/EU, AIFMs shall assess changes in the information referred to in Article 23 of Directive 2011/61/EU during the financial year in accordance with paragraph 1 of this Article.

3. Information shall be disclosed in line with the requirements of the accounting standards and accounting rules adopted by the AIF together with a description of any potential or anticipated impact on the AIF and, as the case may be, or investors in the AIF. Additional disclosures shall be made when compliance with specific requirements of the accounting standards and accounting rules may be insufficient to enable investors to understand the impact of the change.

4. Where the information required to be disclosed in accordance with paragraph 1 is not covered by the accounting standards applicable to an AIF, or its accounting rules, a description of the material change shall be provided together with any potential or anticipated impact on the AIF and, as the case may be, or investors in the AIF.

Article 107

Remuneration disclosure

1. When information required by point (e) of Article 22(2) of Directive 2011/61/EU is given, it shall be specified whether or not the total remuneration relates to any of the following:

(a) the total remuneration of the entire staff of the AIFM, indicating the number of beneficiaries;

(b) the total remuneration of those staff of the AIFM who are fully or partly involved in the activities of the AIF, indicating the number of beneficiaries;

(c) the proportion of the total remuneration of the staff of the AIFM attributable to the AIF, indicating the number of beneficiaries.

2. Where relevant, the total remuneration for the financial year shall also mention the carried interest paid by the AIF.

3. Where information is disclosed at the level of the AIFM, an allocation or breakdown shall be provided in relation to each AIF, in so far as this information exists or is readily available. As part of this disclosure, a description of how the allocation or breakdown has been provided shall be included.

4. AIFMs shall provide general information relating to the financial and non-financial criteria of the remuneration policies and practices for relevant categories of staff to enable investors to assess the incentives created. In accordance with the principles set out in Annex II to Directive 2011/61/EU, AIFMs shall disclose at least the information necessary to provide an understanding of the risk profile of the AIF and the measures it adopts to avoid or manage conflicts of interest.

Article 108

Periodic disclosure to investors

1. The information referred to in Article 23(4) of Directive 2011/61/EU shall be presented in a clear and understandable way.

2. When disclosing the percentage of the AIF's assets which are subject to special arrangements arising from their illiquid nature in accordance with Article 23(4)(a) of Directive 2011/61/EU the AIFM shall:

(a) provide an overview of any special arrangements in place including whether they relate to side pockets, gates or other similar arrangements, the valuation methodology applied to assets which are subject to such arrangements and how management and performance fees apply to these assets;

(b) disclose this information as part of the AIF's periodic reporting to investors, as required by the AIF's rules or instruments of incorporation, or at the same time as the prospectus and offering document and — as a minimum — at the same time as the annual report is made available in accordance with Article 22(1) of Directive 2011/61/EU.

The percentage of the AIF's assets which are subject to special arrangements as defined in Article 1(5) shall be calculated as the net value of those assets subject to special arrangements divided by the net asset value of the AIF concerned.

3. For any new arrangements for managing the liquidity of the AIF in accordance with point (b) of Article 23(4) of Directive 2011/61/EU AIFMs shall:

(a) for each AIF that they manage which is not an unleveraged closed-ended AIF, notify to investors whenever they make changes to the liquidity management systems and procedures referred to in Article 16(1) of Directive 2011/61/EU which are material in accordance with Article 106(1);

(b) immediately notify investors where they activate gates, side pockets or similar special arrangements or where they decide to suspend redemptions;

(c) provide an overview of the changes to arrangements concerning liquidity, whether or not these are special arrangements. Where relevant, the terms under which redemption is permitted and circumstances determining when management discretion applies shall be included. Also any voting or other restrictions exercisable, the length of any lock-up or any provision concerning 'first in line' or 'pro-rating' on gates and suspensions shall be included.

4. The disclosure of the risk profile of the AIF in accordance with point (c) of Article 23(4) of Directive 2011/61/EU shall outline:

(a) measures to assess the sensitivity of the AIF's portfolio to the most relevant risks to which the AIF is or could be exposed;

(b) if risk limits set by the AIFM have been or are likely to be exceeded and where these risk limits have been exceeded a description of the circumstances and, the remedial measures taken.

The information shall be disclosed as part of the AIF's periodic reporting to investors, as required by the AIF's rules or instruments of incorporation or at the same time as the prospectus and offering document and — at a minimum — at the same time as the annual report is made available in accordance with Article 22(1) of Directive 2011/61/EU.

5. The risk management systems employed by the AIFM in accordance with point (c) of Article 23(4) of Directive 2011/61/EU shall outline the main features of the risk management systems employed by the AIFM to manage the risks to which each AIF it manages is or may be exposed. In the case of a change the disclosure shall include the information relating to the change and its anticipated impact on the AIF and its investors.

The information shall be disclosed as part of the AIF's periodic reporting to investors, as required by the AIF's rules or instruments of incorporation or at the same time as the prospectus and offering document and — as a minimum — at the same time as the annual report is made available or made public in accordance with Article 22(1) of Directive 2011/61/EU.

Article 109

Regular disclosure to investors

1. The information referred to in Article 23(5) of Directive 2011/61/EU shall be presented in a clear and understandable way.

2. Information on changes to the maximum level of leverage calculated in accordance with the gross and commitment methods and any right of re-use of collateral or any guarantee under the leveraging arrangements shall be provided without undue delay and shall include:

(a) the original and revised maximum level of leverage calculated in accordance with Articles 7 and 8, whereby the level of leverage shall be calculated as the relevant exposure divided by the net asset value of the AIF;

(b) the nature of the rights granted for the reuse of collateral;

(c) the nature of guarantees granted; and

(d) details of changes in any service providers which relating to one of the items above.

3. Information on the total amount of leverage calculated in accordance with the gross and commitment methods employed by the AIF shall be disclosed as part of the AIF's periodic reporting to investors, as required by the AIF's rules or instruments of incorporation, or at the same time as the prospectus and offering document and at least at the same time as the annual report is made available according to Article 22(1) of Directive 2011/61/EU.

Article 110

Reporting to competent authorities

1. In order to comply with the requirements of the second subparagraph of Article 24(1) and of point (d) of Article 3(3) of Directive 2011/61/EU, an AIFM shall provide the following information when reporting to competent authorities:

(a) the main instruments in which it is trading, including a break-down of financial instruments and other assets, including the AIF's investment strategies and their geographical and sectoral investment focus;

(b) the markets of which it is a member or where it actively trades;

(c) the diversification of the AIF's portfolio, including, but not limited to, its principal exposures and most important concentrations.

The information shall be provided as soon as possible and not later than one month after the end of the period referred to in paragraph 3. Where the AIF is a fund of funds this period may be extended by the AIFM by 15 days.

2. For each of the EU AIFs they manage and for each of the AIFs they market in the Union, AIFMs shall provide to the competent authorities of their home Member State the following information in accordance with Article 24(2) of Directive 2011/61/EU:

(a) the percentage of the AIF's assets which are subject to special arrangements as defined in Article 1(5) of this Regulation arising from their illiquid nature as referred to in point (a) of Article 23(4) of Directive 2011/61/EU;

(b) any new arrangements for managing the liquidity of the AIF;

(c) the risk management systems employed by the AIFM to manage the market risk, liquidity risk, counterparty risk and other risks including operational risk;

(d) the current risk profile of the AIF, including:

(i) the market risk profile of the investments of the AIF, including the expected return and volatility of the AIF in normal market conditions;

(ii) the liquidity profile of the investments of the AIF, including the liquidity profile of the AIF's assets, the profile of redemption terms and the terms of financing provided by counterparties to the AIF;

(e) information on the main categories of assets in which the AIF invested including the corresponding short market value and long market value, the turnover and performance during the reporting period; and

(f) the results of periodic stress tests, under normal and exceptional circumstances, performed in accordance with point (b) of Article 15(3) and the second subparagraph of Article 16(1) of Directive 2011/61/EU.

3. The information referred to in paragraphs 1 and 2 shall be reported as follows:

(a) on a half-yearly basis by AIFMs managing portfolios of AIFs whose assets under management calculated in accordance with Article 2 in total exceed the threshold of either EUR 100 million or EUR 500 million laid down in points (a) and (b) respectively of Article 3(2) of Directive 2011/61/EU but do not exceed EUR 1 billion, for each of the EU AIFs they manage and for each of the AIFs they market in the Union;

(b) on a quarterly basis by AIFMs managing portfolios of AIFs whose assets under management calculated in accordance with Article 2 in total exceed EUR 1 billion, for each of the EU AIFs they manage, and for each of the AIFs they market in the Union;

(c) on a quarterly basis by AIFMs which are subject to the requirements referred to in point (a) of this paragraph, for each AIF whose assets under management, including any assets acquired through use of leverage, in total exceed EUR 500 million, in respect of that AIF;

(d) on an annual basis by AIFMs in respect of each unleveraged AIF under their management which, in accordance with its core investment policy, invests in non-listed companies and issuers in order to acquire control.

4. By way of derogation from paragraph 3, the competent authority of the home Member State of the AIFM may deem it appropriate and necessary for the exercise of its function to require all or part of the information to be reported on a more frequent basis.

5. AIFMs managing one or more AIFs which they have assessed to be employing leverage on a substantial basis in accordance with Article 111 of this Regulation shall provide the information required under Article 24(4) of Directive 2011/61/EU at the same time as that required under paragraph 2 of this Article.

6. AIFMs shall provide the information specified under paragraphs 1, 2 and 5 in accordance with the pro-forma reporting template set out in the Annex IV.

7. In accordance with point (a) of Article 42(1) of Directive 2011/61/EU, for non-EU AIFMs, any reference to the competent authorities of the home Member State shall mean the competent authority of the Member State of reference.

Article 111

Use of leverage on a 'substantial basis'

1. Leverage shall be considered to be employed on a substantial basis for the purposes of Article 24(4) of Directive 2011/61/EU when the exposure of an AIF as calculated according to the commitment method under Article 8 of this Regulation exceeds three times its net asset value.

2. Where the requirements referred to in paragraph 1 of this Article are fulfilled, AIFMs shall provide information in accordance with Article 24(4) of Directive 2011/61/EU to the competent authorities of their home Member States in accordance with the principles laid down in Article 110(3) of this Regulation.

SECTION 2

AIFMs managing leveraged AIFs

(Article 25(3) of Directive 2011/61/EU)

Article 112

Restrictions on the management of AIFs

1. The principles laid down in this Article shall apply in order to specify the circumstances in which competent authorities exercise their power to impose leverage limits or other restrictions on AIFMs.

2. When assessing the information received under Articles 7(3), 15(4), 24(4) or 24(5) of Directive 2011/61/EU, a competent authority shall take into account the extent to which the use of leverage by an AIFM or its interaction with a group of AIFMs or other financial institutions can contribute to the build-up of systemic risk in the financial system or risks creating disorderly markets.

3. Competent authorities shall take into account at least the following aspects in their assessment:

(a) the circumstances in which the exposure of an AIF or several AIFs including those exposures resulting from financing or investment positions entered into by the AIFM for its own account or on behalf of the AIFs could constitute an important source of market, liquidity or counterparty risk to a financial institution;

(b) the circumstances in which the activities of an AIFM or its interaction with, for example, a group of AIFMs or other financial institutions, in particular with respect to the types of assets in which the AIF invests and the techniques employed by the AIFM through the use of leverage, contribute or could contribute to a downward spiral in the prices of financial instruments or other assets in a manner that threatens the viability of such financial instruments or other assets;

(c) criteria such as the type of AIF, the investment strategy of the AIFM with respect to the AIFs concerned, the market conditions in which the AIFM and the AIF operate and any likely pro-cyclical effects that could result from the imposition by the competent authorities of limits or other restrictions on the use of leverage by the AIFM concerned;

(d) criteria, such as the size of an AIF or several AIFs and any related impact in a particular market sector, concentrations of risks in particular markets in which the AIF or several AIFs are investing, any contagion risk to other markets from a market where risks have been identified, liquidity issues in particular markets at a given time, the scale of asset/liability mismatch in a particular AIFM investment strategy or irregular movements in the prices of assets in which an AIF may invest.

SECTION 3

Specific rules relating to third countries

(Articles 34(1), 35(2) 36(1), Articles 37(7)(d), 40(2)(a) and Article 42(1) of Directive 2011/61/EU)

Article 113

General requirements

1. Cooperation arrangements shall cover all possible situations and actors envisaged in Chapter VII of Directive 2011/61/EU taking into account the location of the AIFM, the location of the AIF and the activity of the AIFM.

2. Cooperation arrangements shall take a written form.

3. Cooperation arrangements shall establish the specific framework for consultation, cooperation and exchange of information for supervisory and enforcement purposes between EU competent authorities and third country supervisory authorities.

4. Cooperation arrangements shall include a specific clause providing for the transfer of information received by a Union competent authority from a supervisory authority in a third country to other Union competent authorities, to ESMA or to the ESRB as required under Directive 2011/61/EU.

Article 114

Mechanisms, instruments and procedures

1. Cooperation arrangements shall establish the mechanisms, instruments and procedures required for enabling Union competent authorities to have access to all information necessary for the performance of their duties under Directive 2011/61/EU.

2. Cooperation arrangements shall establish the mechanisms, instruments and procedures required for enabling on-site inspections to be carried out where required for the exercise of the Union competent authority's duties under Directive 2011/61/EU. On-site inspections shall be carried out directly by the Union competent authority or by the third country competent authority with the assistance of the Union competent authority.

3. Cooperation arrangements shall establish the mechanisms, instruments and procedures required for the third country competent authority to assist the Union competent authorities where it is necessary to enforce Union legislation and national implementing legislation breached by an entity established in the third country, in accordance with the national and international law applicable to that authority.

Article 115

Data protection

Cooperation arrangements shall ensure that the transfer to third countries of data and the analysis of data takes place only in accordance with Article 52 of Directive 2011/61/EU.

SECTION 4

Exchange of information on the potential systemic consequences of AIFM activity

(Article 53(1) of Directive 2011/61/EU)

Article 116

Exchange of information on the potential systemic consequences of AIFM activity

For the purposes of Article 53 of Directive 2011/61/EU, the competent authorities of the Member States responsible for the authorisation or supervision of AIFMs under that Directive shall exchange with the competent authorities of other Member States, and with ESMA and the ESRB at least:

(a) the information received pursuant to Article 110, whenever such information may be relevant for monitoring and responding to the potential implications of the activities of individual AIFMs or several AIFMs collectively for the stability of systemically relevant financial institutions and the orderly functioning of markets on which the AIFMs are active;

(b) the information received from third country authorities whenever this is necessary for the monitoring of systemic risks;

(c) the analysis of the information referred to in points (a) and (b) and the assessment of any situation in which the activities of one or more supervised AIFMs or of one or more AIFs under their management are considered to contribute to the build-up of systemic risk in the financial system, to the risk of disorderly markets or to risks for the long-term growth of the economy;

(d) the measures taken, when the activity of one or more supervised AIFMs or of one or more AIFs under their management present systemic risk or jeopardise the orderly functioning of the markets on which they are active.

CHAPTER VI

FINAL PROVISIONS

Article 117

Entry into force

This Regulation shall enter into force on the twentieth day following that of its publication in the *Official Journal of the European Union*.

It shall apply from 22 July 2013.

This Regulation shall be binding in its entirety and directly applicable in all Member States.

Done at Brussels, 19 December 2012.

For the Commission
The President
José Manuel BARROSO

ANNEX I

Methods of increasing the exposure of an AIF

1. Unsecured cash borrowings: When cash borrowings are invested they have the propensity to increase the exposure of the AIF by the total amount of those borrowings. Therefore, the minimum exposure is always the amount of the borrowing. It might be higher if the value of the investment realised with the borrowing is greater than the borrowed amount. To avoid double counting, cash borrowings that are used to finance the exposure shall not be included within the calculation. If the cash borrowings are not invested but remain in cash or cash equivalent as defined in Article 7(a) they will not increase the exposure of the AIF.

2. Secured cash borrowings: Secured cash borrowings are similar to unsecured cash borrowings but the loan may be secured by a pool of assets or a single asset. If the cash borrowings are not invested but remain in cash or cash equivalent as defined in Article 7(a) they will not increase the exposure of the AIF.

3. Convertible borrowings: Convertible borrowings are purchased debt which has the ability, under certain circumstances, to enable the holder or issuer to convert that debt into another asset. The exposure of the AIF is the market value of such borrowings.

4. Interest rate swaps: An interest rate swap is an agreement to exchange interest rate cash flows, calculated on a notional principal amount, at specified intervals (payment dates) during the life of the agreement. Each party's payment obligation is computed using a different interest rate based on the notional exposures.

5. Contracts for differences: A contract for differences (CFD) is an agreement between two parties — the investor and the CFD provider — to pay the other the change in the price of an underlying asset. Depending on which way the price moves, one party pays the other the difference from the time the contract was agreed to the point in time where it ends. Exposure is the market value of the underlying asset. The same treatment must be applied to financial spread bets.

6. Futures contracts: A futures contract is an agreement to buy or sell a stated amount of a security, currency, commodity, index or other asset at a specific future date and at a pre-agreed price. The exposure is the market value of the equivalent underlying asset.

7. Total return swaps: A total return swap is an agreement in which one party (total return payer) transfers the total economic performance of a reference obligation to the other party (total return receiver). Total economic performance includes income from interest and fees, gains or losses from market movements, and credit losses. The exposure of the AIF is the market value of the equivalent reference assets which have a bearing on the economic performance of the swap.

8. Forward agreements: A forward agreement is a customised, bilateral agreement to exchange an asset or cash flows at a specified future settlement date at a forward price agreed on the trade date. One party to the forward is the buyer (long), who agrees to pay the forward price on the settlement date; the other is the seller (short), who agrees to receive the forward price. Entering into a forward contract typically does not require the payment of a fee. The exposure of the AIF is the market value of the equivalent underlying asset. This may be replaced by the notional value of the contract where this is more conservative.

9. Options: An option is an agreement that gives the buyer, who pays a fee (premium), the right — but not the obligation — to buy or sell a specified amount of an underlying asset at an agreed price (strike or exercise price) on or until the expiration of the contract (expiry). A call option is an option to buy, and a put option an option to sell. The bounds of the exposure of the fund will be on the one side a potential unlimited exposure and on the other side an exposure that is limited to the higher of the premium paid or the market value of that option. The exposure between these two bounds is determined as the delta (an options delta measures the sensitivity of an option's price solely to a change in the price of the underlying asset) adjusted equivalent of the underlying position. The same approach must be adopted for embedded derivatives, e.g. in structured products. The structure should be broken down into its component parts and the effect of layers of derivative exposures must be adequately captured.

10. Repurchase agreements: The repurchase agreement normally occurs where an AIF 'sells' securities to a reverse-repo counterparty and agrees to buy them back at an agreed price in the future. The AIF will incur a financing cost from engaging in this transaction and will therefore need to re-invest the cash proceeds (effectively cash collateral) in order to generate a return greater than the financing cost incurred. This reinvestment of 'cash collateral' means that incremental market risk will be carried by the AIF and consequently must be taken into account in the global exposure calculation. The economic risks and rewards of the 'sold' securities remain with the AIF. Also, a repo transaction will almost always give rise to leverage as the cash collateral will be reinvested. In the event that non-cash collateral is received as part of the transaction and this collateral is further used as part of another repo, or stock-loan agreement, the full market value of the collateral must be included in the global exposure amount. The exposure of the AIF is increased by the reinvested part of the cash collateral.

11. Reverse repurchase agreements: This transaction occurs where an AIF 'purchases' securities from a repo counterparty and agrees to sell them back at an agreed price in the future. AIFs normally engage in these transactions to generate a low-risk money-market type return, and the 'purchased' securities act as collateral. Therefore no global exposure is generated; nor does the AIF take on the risks and rewards of the 'purchased' securities, i.e. there is no incremental market risk. However, it is possible for the 'purchased' securities to be further used as part of a repo or security-loan transaction, as described above, and in that case the full market value of the securities must be included in the global exposure amount. The economic risks and rewards of the purchased securities remain with the counterparty and therefore this does not increase the exposure of the AIF.

12. Securities lending arrangements: An AIF engaging in a securities lending transaction will lend a security to a security-borrowing counterparty (who will normally borrow the security to cover a physical short sale transaction) for an agreed fee. The security borrower will deliver either cash or non-cash collateral to the AIF. Only where cash collateral is reinvested in instruments other than those defined in Article 7 point (a) will global exposure be created. If the non-cash collateral is further used as part of a repo or another security lending transaction, the full market value of the securities must be included in the global exposure amount as described above. Exposure is created to the extent that the cash collateral has been reinvested.

13. Securities borrowing arrangements: An AIF engaging in the borrowing of securities will borrow a security from a security-lending counterparty for an agreed fee. The AIF will then sell the security in the market. The AIF is now short that security. To the extent that the cash proceeds from the sale are reinvested this will also increase the exposure of the AIF. Exposure is the market value of the shorted securities; additional exposure is created to the extent that the cash received is reinvested.

14. Credit default swaps: A credit default swap (CDS) is a credit derivative agreement that gives the buyer protection, usually the full recovery, in case the reference entity defaults or suffers a credit event. In return the seller of the CDS receives from the buyer a regular fee, called the spread. For the protection seller, the exposure is the higher of the market value of the underlying reference assets or the notional value of the credit default swap. For the protection buyer, the exposure is the market value of the underlying reference asset.

ANNEX II

Conversion methodologies for derivative instruments

1. The following conversion methods shall be applied to the non-exhaustive list below of standard derivatives:

(a) Futures

— Bond future: Number of contracts * notional contract size * market price of the cheapest-to-deliver reference bond

— Interest rate future: Number of contracts * notional contract size

— Currency future: Number of contracts * notional contract size

— Equity future: Number of contracts * notional contract size * market price of underlying equity share

— Index futures: Number of contracts * notional contract size * index level

(b) Plain vanilla options (bought/sold puts and calls)

— Plain vanilla bond option: Notional contract value * market value of underlying reference bond * delta

— Plain vanilla equity option: Number of contracts * notional contract size* market value of underlying equity share * delta

— Plain vanilla interest rate option: Notional contract value * delta

— Plain vanilla currency option: Notional contract value of currency leg(s) * delta

— Plain vanilla index options: Number of contracts * notional contract size * index level * delta

— Plain vanilla options on futures: Number of contracts * notional contract size * market value of underlying asset * delta

— Plain vanilla swaptions: Reference swap commitment conversion amount * delta

— Warrants and rights: Number of shares/bonds * market value of underlying referenced instrument * delta

(c) Swaps

— Plain vanilla fixed/floating rate interest rate and inflation swaps: notional contract value

— Currency swaps: Notional value of currency leg(s)

— Cross currency interest rate swaps: Notional value of currency leg(s)

— Basic total return swap: Underlying market value of reference asset(s)

— Non-basic total return swap: Cumulative underlying market value of both legs of the TRS

— Single name credit default swap:

Protection seller — The higher of the market value of the underlying reference asset or the notional value of the Credit Default Swap.

Protection buyer — Market value of the underlying reference asset

— Contract for differences: Number of shares/bonds * market value of underlying referenced instrument

(d) Forwards

— FX forward: notional value of currency leg(s)

— Forward rate agreement: notional value

(e) Leveraged exposure to indices with embedded leverage

A derivative providing leveraged exposure to an underlying index, or indices that embed leveraged exposure to their portfolio, must apply the standard applicable commitment approach to the assets in question.

2. The following conversion methods shall be applied to the non-exhaustive list below of financial instruments which embed derivatives:

   — Convertible bonds: Number of referenced shares * market value of underlying referenced shares * delta

   — Credit linked notes: Market value of underlying reference asset(s)

   — Partly paid securities: Number of shares/bonds * market value of underlying referenced instruments

   — Warrants and rights: Number of shares/bonds * market value of underlying referenced instrument * delta

3. List of examples of non-standard derivatives with the related commitment methodology being used:

   — Variance swaps: Variance swaps are contracts that allow investors to gain exposure to the variance (squared volatility) of an underlying asset and, in particular, to trade future realised (or historical) volatility against current implied volatility. According to market practice, the strike and the variance notional are expressed in terms of volatility. For the variance notional, this gives:

   $$\text{variance notional} = \frac{\text{vega notional}}{2 \times \text{strike}}$$

   The vega notional provides a theoretical measure of the profit or loss resulting from a 1 % change in volatility.

   As realised volatility cannot be less than zero, a long swap position has a known maximum loss. The maximum loss on a short swap is often limited by the inclusion of a cap on volatility. However without a cap, a short swap's potential losses are unlimited.

   The conversion methodology to be used for a given contract at time t is:

   Variance notional * (current) variance_t (without volatility cap)

   Variance notional * min [(current) variance_t volatility cap^2] (with volatility cap)

   whereby: (current) variance_t is a function of the squared realised and implied volatility, more precisely:

   $$\text{(current) variance}_t = \frac{t}{T} \times \text{realized volatility } (0,t)^2 + \frac{T-t}{T} \times \text{implied volatility } (t,T)^2$$

   — Volatility swaps

   By analogy with the variance swaps, the following conversion formulae should be applied to volatility swaps:

   — Vega notional * (current) volatility_t (without volatility cap)

   — Vega notional * min [(current) volatility_t; volatility cap] (with volatility cap)

   whereby the (current) volatility t is a function of the realised and implied volatility.

4. Barrier (knock-in knock-out) options

   Number of contracts * notional contract size * market value of underlying equity share * delta

ANNEX III

Duration netting rules

1. An interest rate derivative shall be converted into its equivalent underlying asset position in accordance with the following methodology:

   The equivalent underlying asset position of each interest rate derivative instrument shall be calculated as its duration divided by the target duration of the AIF and multiplied by the equivalent underlying asset position:

$$\textit{Equivalent underlying asset position} = \frac{\textit{duration}_{\text{FDI}}}{\textit{duration}_{\text{target}}} \times \text{CV}_{\text{derivative}}$$

   where:

   — $\textit{duration}_{\text{FDI}}$ is the duration (sensitivity of the market value of the financial derivative instrument to interest rate movements) of the interest rate derivative instrument,

   — $\textit{duration}_{\text{target}}$ is in line with the investment strategy, the directional positions and the expected level of risk at any time and will be regularised otherwise. It is also in line with the portfolio duration under normal market conditions,

   — $\text{CV}_{\text{derivative}}$ is the converted value of the derivative position as defined by the Annex II.

2. The equivalent underlying asset positions calculated in accordance with to paragraph 1 shall be netted as follows:

   (a) Each interest rate derivative instrument shall be allocated to the appropriate maturity range of the following maturity-based ladder:

   Maturities ranges

   1. 0-2 years

   2. 2-7 years

   3. 7-15 years

   4. > 15 years

   (b) The long and short equivalent underlying asset positions shall be netted within each maturity range. The amount of the former which is netted with the latter is the netted amount for that maturity range.

   (c) Starting with the shortest maturity range, the netted amounts between two adjoining maturity ranges shall be calculated by netting the amount of the remaining unnetted long (or short) position in the maturity range (i) with the amount of the remaining unnetted short (long) position in the maturity range (i + 1).

   (d) Starting with the shortest maturity range, the netted amounts between two remote maturity ranges separated by another one shall be calculated by netting the amount of the remaining unnetted long (or short) position in the maturity range (i) with the amount of the remaining unnetted short (long) position in the maturity range (i + 2).

   (e) The netted amount shall be calculated between the remaining unnetted long and short positions of the two most remote maturity ranges.

3. The AIF shall calculate its exposures as the sum of absolute values:

   — 0 % of the netted amount for each maturity range,

   — 40 % of the netted amounts between two adjoining maturity ranges (i) and (i + 1),

   — 75 % of the netted amounts between two remote maturity ranges separated by another one, meaning maturity ranges (i) and (i + 2),

   — 100 % of the netted amounts between the two most remote maturity ranges, and

   — 100 % of the remaining unnetted positions.

ANNEX IV

Reporting Templates: AIFM

(Articles 3(3)(d) and 24 of Directive 2011/61/EU)

AIFM-specific information to be reported

(Articles 3(3)(d) and 24(1) of Directive 2011/61/EU)

		Most important market/instrument	Second most important market/instrument	Third most important market/instrument	Fourth most important market/instrument	Fifth most important market/instrument
1	**Principal markets in which it trades on behalf of the AIFs it manages**					
2	**Principal instruments in which it trades on behalf of the AIFs it manages**					
3	**Values of assets under management for all AIFs managed, calculated as set out in Article 2**	**In base currency (if the same for all AIFs)**		**In EUR**		
	Please provide official name, location and jurisdiction of markets					

Detailed list of all AIFs which the AIFM manages

to be provided on request for the end of each quarter

(Article 24(3) of Directive 2011/61/EU)

Name of the AIF	Fund identification code						Inception date	AIF type (Hedge Fund, Private Equity, Real Estate, Fund of Funds, Other (*))	NAV	EU AIF: Yes/No

(*) If Other please indicate the strategy that best describes the AIF type.

Monetary values should be reported in the base currency of the AIF.

Reporting Templates: AIF

(Articles 3(3)(d) and 24 of Directive 2011/61/EU)

AIF-specific information to be provided

(Articles 3(3)(d) and 24(1) of Directive 2011/61/EU)

	Data Type		Reported Data	
	Identification of the AIF			
1	**AIF name**		EU AIF: yes/no	
2	**Fund manager** *(Legal name and standard code, where available)*		EU AIFM: yes/no	
3	**Fund identification codes**, as applicable			
4	**Inception date of the AIF**			
5	**Domicile of the AIF**			
6	**Identification of prime broker(s) of the AIF** *(Legal name and standard code, where available)*			
7	**Base currency of the AIF according to ISO 4217 and assets under management calculated as set out in Article 2**		Currency	Total AuM
8	**Jurisdictions of the three main funding sources** (excluding units or shares of the AIF bought by investors)			
9	**Predominant AIF type** *(select one)*		Hedge Fund Private Equity Fund Real Estate Fund Fund of Funds Other None	
10	**Breakdown of investment strategies** *(Provide a breakdown of the investment strategies of the AIF depending on the predominant AIF type selected in question 1. See guidance notes for further information on how to complete this question.)*			

	Data Type	Reported Data	
		Indicate the strategy that best describe the AIF's strategy	Share in NAV (%)
	a) Hedge Fund Strategies *(Complete this question if you selected 'Hedge Fund' as the predominant AIF type in question 1.)*		
	Indicate the hedge fund strategies that best describe the AIFs strategies Equity: Long Bias Equity: Long/Short Equity: Market Neutral Equity: Short Bias Relative Value: Fixed Income Arbitrage Relative Value: Convertible Bond Arbitrage Relative Value: Volatility Arbitrage Event Driven: Distressed/Restructuring Event Driven: Risk Arbitrage/Merger Arbitrage Event Driven: Equity Special Situations Credit Long/Short Credit Asset Based Lending Macro Managed Futures/CTA: Fundamental Managed Futures/CTA: Quantitative Multi-strategy hedge fund Other hedge fund strategy		
	b) Private Equity Strategies *(Complete this question if you selected 'Private Equity' as the predominant AIF type in question 1.)*		
	Indicate the private equity strategies that best describe the AIFs strategies Venture Capital Growth Capital Mezzanine Capital Multi-strategy private equity fund Other private equity fund strategy		

	Data Type	Reported Data	
	c) Real Estate Strategies *(Complete this question if you selected 'Real Estate' as the predominant AIF type in question 1.)*		
	Indicate the real estate strategies that best describe the AIFs strategies Residential real estate Commercial real estate Industrial real estate Multi-strategy real estate fund Other real estate strategy		
	d) Fund of Fund Strategies *(Complete this question if you selected 'Fund of Funds' as the predominant AIF type in question 1.)*		
	Indicate the 'fund of fund' strategy that best describe the AIFs strategies Fund of hedge funds Fund of private equity Other fund of funds		
	e) Other Strategies *(Complete this question if you selected 'Other' as the predominant AIF type in question 1.)*		
	Indicate the 'other' strategy that best describe the AIFs' strategies Commodity fund Equity fund Fixed income fund Infrastructure fund Other fund		

	Data Type			Reported Data	
	Principal exposures and most important concentration				
11	**Main instruments in which the AIF is trading**				
		Type of instrument/instrument code	Value (as calculated under Article 3 AIFMD)	Long/short position	
	Most important instrument				
	2nd most important instrument				
	3rd most important instrument				
	4th most important instrument				
	5th most important instrument				
12	**Geographical focus**				
	Provide a geographical breakdown of the investments held by the AIF by percentage of the total net asset value of the AIF			*% of NAV*	
	Africa				
	Asia and Pacific (other than Middle East)				
	Europe (EEA)				
	Europe (other than EEA)				
	Middle East				
	North America				
	South America				
	Supranational/multiple region				

	Data Type						Reported Data
13	**10 principal exposures of the AIF at the reporting date** (most valuable in absolute terms):						
		Type of asset/liability	Name/description of the asset/liability	Value (as calculated under Article 3)	% of gross market value	Long/short position	Counterparty (where relevant)
	1st						
	2nd						
	3rd						
	4th						
	5th						
	6th						
	7th						
	8th						
	9th						
	10th						
14	**5 most important portfolio concentrations:**						
		Type of asset/liability	Name/description of the market	Value of aggregate exposure (as calculated under Article 3)	% of gross market value	Long/short position	Counterparty (where relevant)
	1st						
	2nd						
	3rd						
	4th						
	5th						

	Data Type	Reported Data	
15	**Typical deal/position size** *(Complete this question if you selected as your predominant AIF type 'private equity fund' in question 1)*	*[Select one]* Very small Small Lower mid market Upper mid market Large cap Mega cap	
16	**Principal markets in which AIF trades**		
	Please enter name and identifier (e.g. MIC code) where available, of market with greatest exposure		
	Please enter name and identifier (e.g. MIC code) where available, of market with second greatest exposure		
	Please enter name and identifier (e.g. MIC code) where available, of market with third greatest exposure		
17	**Investor Concentration**		
	Specify the approximate percentage of the AIF's equity that is beneficially owned by the five beneficial owners that have the largest equity interest in the AIF (as a percentage of outstanding units/shares of the AIF; **look-through to the beneficial owners where known or possible**)		
	Breakdown of investor concentration by status of investors (estimate if no precise information available):	%	
	— Professional clients (as defined in Directive 2004/39/EC (MiFID): — Retail investors:		

Monetary values should be reported in the base currency of the AIF.

AIF-specific information to be provided to competent authorities

(Article 24(2) of Directive 2011/61/EU)

	Data Type		Reported Data	
	Identification of the AIF			
1	**AIF name**		EU AIF: yes/no	
2	**Fund manager**		EU AIFM: yes/no	
1	AIF name			
2	Fund manager			
3	Fund identification codes, as applicable			
4	Inception date of the AIF			
5	Base currency of the AIF **according to ISO 4217 and assets under management calculated as set out in Article 2**		Currency	Total AuM
6	Identification of prime broker(s) of the AIF			
7	Jurisdictions of the three main funding sources			
	Instruments Traded and Individual Exposures			
8	**Individual Exposures in which it is trading and the main categories of assets in which the AIF invested as at the reporting date:**			
	a) Securities		*Long Value*	*Short Value*
	Cash and cash equivalents			
	Of which are:	*Certificates of deposit*		
		Commercial papers		
		Other deposits		
		Other cash and cash equivalents (excluding government securities)		
	Listed equities			
	Of which are:	*Issued by financial institutions*		
		Other listed equity		
	Unlisted equities			
	Corporate bonds not issued by financial institutions			
	Of which are:	*Investment grade*		

	Data Type		Reported Data	
		Non-investment grade		
	Corporate bonds issued by financial institutions			
	Of which are:	*Investment grade*		
		Non-investment grade		
	Sovereign bonds			
	Of which are:	*EU bonds with a 0-1 year term to maturity*		
		EU bonds with a 1 + year term to maturity		
		Non-G10 bonds with a 0-1 year term to maturity		
		Non-G10 bonds with a 1 + year term to maturity		
	Convertible bonds not issued by financial institutions			
	Of which are:	*Investment grade*		
		Non-investment grade		
	Convertible bonds issued by financial institutions			
	Of which are:	*Investment grade*		
		Non-investment grade		

	Data Type		Reported Data	
	Loans			
	Of which are:	*Leveraged loans*		
		Other loans		
	Structured/securitised products			
	Of which are:	*ABS*		
		RMBS		
		CMBS		
		Agency MBS		
		ABCP		
		CDO/CLO		
		Structured certificates		
		ETP		
		Other		
	b) Derivatives		*Long Value*	*Short Value*
	Equity derivatives			
	Of which are:	*Related to financial institutions*		
		Other equity derivatives		

INCLUDES COMMENT LETTERS

	Data Type		Reported Data	
	Fixed income derivatives			
	CDS			
	Of which are:	*Single name financial CDS*		
		Single name sovereign CDS		
		Single name other CDS		
		Index CDS		
		Exotic (incl. credit default tranche)		
			Gross Value	
	Foreign exchange (for investment purposes)			
	Interest rate derivatives			
			Long Value	*Short Value*
	Commodity derivatives			
	Of which are:	*Energy*		
		Of which:		
		— *Crude oil*		
		— *Natural gas*		
		— *Power*		
		Precious metals		
		Of which: Gold		
		Other commodities		
		Of which:		
		— *Industrial metals*		
		— *Livestock*		

	Data Type		Reported Data	
		— *Agricultural products*		
	Other derivatives			
	c) Physical (Real/Tangible) Assets		*Long Value*	
	Physical: Real estate			
	Of which are:	*Residential real estate*		
		Commercial real estate		
	Physical: Commodities			
	Physical: Timber			
	Physical: Art and collectables			
	Physical: Transportation assets			
	Physical: Other			
	d) Collective Investment Undertakings		*Long Value*	
	Investments in CIU operated/managed by the AIFM			
	Of which are:	*Money Market Funds and Cash management CIU*		
		ETF		
		Other CIU		
	Investments in CIU not operated/managed by the AIFM			
	Of which are:	*Money Market Funds and Cash management CIU*		
		ETF		

	Data Type		Reported Data	
		Other CIU		
	e) Investments in other asset classes		*Long Value*	*Short Value*
	Total Other			
9	**Value of turnover in each asset class over the reporting months**			
	a) Securities		*Market Value*	
	Cash and cash equivalents			
	Listed equities			
	Unlisted equities			
	Corporate bonds not issued by financial institutions			
	Of which are:	*Investment grade*		
		Non-investment grade		
	Corporate bonds issued by financial institutions			
	Sovereign bonds			
	Of which are:	*EU Member State bonds*		
		Non-EU Member State bonds		
	Convertible bonds			
	Loans			
	Structured/securitised products			

	Data Type		Reported Data	
	b) Derivatives		*Notional Value*	*Market Value*
	Equity derivatives			
	Fixed income derivatives			
	CDS			
	Foreign exchange (for investment purposes)			
	Interest rate derivatives			
	Commodity derivatives			
	Other derivatives			
	c) Physical (Real/Tangible) Assets		*Market Value*	
	Physical: Commodities			
	Physical: Real estate			
	Physical: Timber			
	Physical: Art and collectables			
	Physical: Transportation assets			
	Physical: Other			
	d) Collective investment undertakings			
	e) Other asset classes			
	Currency of Exposures			

	Data Type		Reported Data	
10	**Total long and short value of exposures (before currency hedging) by the following currency groups:**		*Long Value*	*Short Value*
	AUD			
	CAD			
	CHF			
	EUR			
	GBP			
	HKD			
	JPY			
	USD			
	Other			
11	**Typical deal/position size** (Complete this question if you selected as your predominant AIF type 'private equity fund' above)		*[Select one]* Very small (< EUR 5 m) Small (EUR 5 m to < EUR 25 m) Low/mid market (EUR 25 m to < EUR 150 m) Upper mid market (EUR 150 m to EUR 500 m) Large cap (EUR 500 m to EUR 1 bn) Mega cap (EUR 1 bn and greater)	

	Data Type		Reported Data	
12	**Dominant Influence (see Article 1 of Council Directive 83/349/EEC (OJ L 193, 18.7.1983, p. 1))** *(Complete this question if you selected as your predominant AIF type 'private equity fund' above; please complete for each company over which the AIF has a dominant influence (leave blank if none) as defined in Article 1 of Directive 83/349/EEC)*	*Name*	*% Voting Rights*	*Transaction Type*

Risk Profile of the AIF

	1. Market Risk Profile			
13	**Expected annual investment return/IRR in normal market conditions (in %)**			
	Net Equity Delta			
	Net DV01:			
	Net CS01:			
	2. Counterparty Risk Profile			
14	**Trading and clearing mechanisms**			
	a) Estimated % (in terms of market value) of securities traded: *(leave blank if no securities traded)*		%	
	On a regulated exchange			
	OTC			
	b) Estimated % (in terms of trade volumes) of derivatives that are traded: *(leave blank if no derivatives traded)*		%	
	On a regulated exchange			
	OTC			

	Data Type		Reported Data	
	c) Estimated % (in terms of trade volumes) of derivatives transactions cleared: *(leave blank if no derivatives traded)*		%	
	By a CCP			
	Bilaterally			
	d) Estimated % (in terms of market value) of repo trades cleared: *(leave blank if no repos traded)*		%	
	By a CCP			
	Bilaterally			
	Tri-party			
15	**Value of collateral and other credit support that the AIF has posted to all counterparties**			
	a) Value of collateral posited in the form of cash and cash equivalents			
	b) Value of collateral posited in the form of other securities (excluding cash and cash equivalents)			
	c) Value of other collateral and credit support posted (including face amount of letters of credit and similar third party credit support)			
16	**Of the amount of collateral and other credit support that the reporting fund has posted to counterparties: what percentage has been re-hypothecated by counterparties?**			
17	**Top Five Counterparty Exposures (excluding CCPs)**			
	a) Identify the top five counterparties to which the AIF has the greatest mark-to-market net counterparty credit exposure, measured as a % of the NAV of the AIF		*Name*	*Total Exposure*
	Counterparty 1			

	Data Type		Reported Data	
	Counterparty 2			
	Counterparty 3			
	Counterparty 4			
	Counterparty 5			
	b) Identify the top five counterparties that have the greatest mark-to-market net counterparty credit exposure to the AIF, measured as a percentage of the NAV of the AIF.		*Name*	*Total Exposure*
	Counterparty 1			
	Counterparty 2			
	Counterparty 3			
	Counterparty 4			
	Counterparty 5			
18	**Direct clearing through central clearing counterparties (CCPs)**			
	a) During the reporting period, did the AIF clear any transactions directly through a CCP?		Yes No (if no, skip remainder of the question and go to question 21)	
	b) If you answered 'yes' in 18(a), identify the top three central clearing counterparties (CCPs) in terms of net credit exposure		*Name*	*Value held*
	CCP 1 *(leave blank if not applicable)*			
	CCP 2 *(leave blank if not applicable)*			
	CCP 3 *(leave blank if not applicable)*			
	3. Liquidity Profile			
	Portfolio Liquidity Profile			

	Data Type						Reported Data	
19	**Investor Liquidity Profile** Percentage of portfolio capable of being liquidated within:							
	1 day or less	2-7 days	8-30 days	31-90 days	91-180 days	181-365 days	more than 365 days	
20	**Value of unencumbered cash**							
	Investor Liquidity Profile							
21	**Investor Liquidity Profile** Percentage of investor equity that can be redeemed within (as % of AIF's NAV)							
	1 day or less	2-7 days	8-30 days	31-90 days	91-180 days	181-365 days	more than 365 days	
22	**Investor redemptions**							
	a) Does the AIF provide investors with withdrawal/redemption rights in the ordinary course?						Yes	No
	b) What is the frequency of investor redemptions (if multiple classes of shares or units, report for the largest share class by NAV)						*[Select one]* Daily Weekly Fortnightly Monthly Quarterly Half-yearly Annual Other N/A	
	c) What is the notice period required by investors for redemptions in days *(report asset weighted notice period if multiple classes or shares or units)*							

	Data Type		Reported Data	
	d) What is the investor 'lock-up' period in days (report asset weighted notice period if multiple classes or shares or units)			
23	**Special arrangements and preferential treatment**			
	a) As at the reporting date, what percentage of the AIFs NAV is subject to the following arrangements:		*% of NAV*	
	Side pockets			
	Gates			
	Suspension of dealing			
	Other arrangements for managing illiquid assets *(please specify)*		[Type]	[%]
	b) Indicate the percentage of net asset value of AIF's assets that are currently subject to the special arrangements arising from their illiquid nature under Article 23(4)(a) of the AIFMD including those in question 25(a)?			
	Special arrangements as a % of NAV			
	c) Are there any investors who obtain preferential treatment or the right to preferential treatment (e.g. through a side letter) and therefore are subject to disclosure to the investors in the AIF in accordance with Article 23(1)(j) of the AIFMD?		(Yes or no)	
	d) If 'yes' to letter c) then please indicate all relevant preferential treatment:			
	Concerning different disclosure/reporting to investors			
	Concerning different investor liquidity terms			
	Concerning different fee terms for investors			
	Preferential treatment other than that specified above			

	Data Type						Reported Data	
24	**Provide the breakdown of the ownership of units in the AIF by investor group (as % of NAV of AIF assets; look-through to the beneficial owners where known or possible)**							
25	**Financing liquidity**							
	a) Provide the aggregate amount of borrowing by and cash financing available to the AIF (including all drawn and undrawn, committed and uncommitted lines of credit as well as any term financing)							
	b) Divide the amount reported in letter a) among the periods specified below depending on the longest period for which the creditor is contractually committed to provide such financing:							
	1 day or less	2-7 days	8-30 days	31-90 days	91-180 days	181-365 days	longer than 365 days	
	4. Borrowing and Exposure Risk							
26	**Value of borrowings of cash or securities represented by:**							
	Unsecured cash borrowing:							
	Collateralised/secured cash borrowing — Via Prime Broker:							
	Collateralised/secured cash borrowing — Via (reverse) repo:							
	Collateralised/secured cash borrowing — Via Other:							
27	**Value of borrowing embedded in financial instruments**							
	Exchange-traded Derivatives: Gross Exposure less margin posted							
	OTC Derivatives: Gross Exposure less margin posted							

	Data Type		Reported Data	
28	**Value of securities borrowed for short positions**			
29	**Gross exposure of financial and, as the case may be, or legal structures controlled by the AIF as defined in Recital 78 of the AIFMD**			
	Financial and, as the case may be, or legal structure			
	Financial and, as the case may be, or legal structure			
	Financial and, as the case may be, or legal structure			
	…			
30	**Leverage of the AIF**			
	a) as calculated under the Gross Method			
	b) as calculated under the Commitment Method			
	5. Operational and Other Risk Aspects			
31	**Total number of open positions**			
32	**Historical risk profile**			
	a) Gross Investment returns or IRR of the AIF over the reporting period (in %, gross of management and performance fees)			
	1st Month of Reporting Period			
	2nd Month of Reporting Period			
	…			
	…			
	Last Month of Reporting Period			
	b) Net Investment returns or IRR of the AIF over the reporting period (in %, net of management and performance fees)			
	1st Month of Reporting Period			

	Data Type		Reported Data	
	2nd Month of Reporting Period			
	…			
	…			
	Last Month of Reporting Period			
	c) Change in Net Asset Value of the AIF over the reporting period (in %, including the impact of subscriptions and redemptions)			
	1st Month of Reporting Period			
	2nd Month of Reporting Period			
	…			
	…			
	Last Month of Reporting Period			
	d) Subscriptions over the reporting period			
	1st Month of Reporting Period			
	2nd Month of Reporting Period			
	…			
	…			
	Last Month of Reporting Period			
	e) Redemptions over the reported period			
	1st Month of Reporting Period			
	2nd Month of Reporting Period			
	…			
	…			
	Last Month of Reporting Period			

Monetary values should be reported in the base currency of the AIF.

Results of stress tests

Please provide the **results of the stress tests** performed in accordance with point (b) of **Article 15(3) of Directive 2011/61/EU** *[risks associated with each investment position of the AIF and their overall effect on the AIF's portfolio can be properly identified, measured, managed and monitored on an ongoing basis, including through the use of appropriate stress testing procedures;] (free text)*

Monetary values should be reported in the base currency of the AIF.

Please provide the **results of the stress tests** performed in accordance with the **second subparagraph of Article 16(1) of Directive 2011/61/EU.** [*AIFMs shall regularly conduct stress tests, under normal and exceptional liquidity conditions, which enable them to assess the liquidity risk of the AIFs and monitor the liquidity risk of the AIFs accordingly.] (free text)*

Monetary values should be reported in the base currency of the AIF.

AIF-specific information to be made available to the competent authorities

(Article 24(4) of Directive 2011/61/EU)

	Data Type	Reported Data	
1	**Of the amount of collateral and other credit support that the reporting AIF has posted to counterparties: what percentage has been re-hypothecated by counterparties?**		
	Borrowing and Exposure Risk		
2	**Value of borrowings of cash or securities represented by:**		
	Unsecured cash borrowing:		
	Collateralised/secured cash borrowing — Via Prime Broker:		
	Collateralised/secured cash borrowing — Via (reverse) repo:		
	Collateralised/secured cash borrowing — Via Other:		
3	**Value of borrowing embedded in financial instruments**		
	Exchange-traded Derivatives: Gross Exposure less margin posted		

	Data Type	Reported Data	
	OTC Derivatives: Gross Exposure less margin posted		
4	**Five largest sources of borrowed cash or securities (short positions):**		
	Largest:		
	2nd largest:		
	3rd largest:		
	4th largest:		
	5th largest:		
5	**Value of securities borrowed for short positions**		
6	**Gross exposure of financial and, as the case may be, or legal structures controlled by the AIF as defined in Recital 78 of the AIFMD**		
	Financial and, as the case may be, or legal structure		
	Financial and, as the case may be, or legal structure		
	Financial and, as the case may be, or legal structure		
	…		
7	**Leverage of the AIF:**		
	a) Gross Method		
	b) Commitment Method		

Monetary values should be reported in the base currency of the AIF.

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December 22, 2016

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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20 Queen Street West, 19th Floor,
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– and –

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

Dear Sirs/Medames:

We are pleased to provide the CSA with comments on the recently published Proposed Rules, which would repeal National Instrument 81-104 *Commodity Pools* ("**NI 81-104**") and propose a number of amendments to National Instrument 81-102 – *Investment Funds* ("**NI 81-102**"), as they reflect issues that directly impact the registrants we service.

AUM Law is a boutique securities law firm with offices in Toronto and Montreal, providing regulatory compliance, fund formation, and corporate finance advice. We deliver practical and forward-thinking advice and services to our clients, consisting primarily of portfolio managers, fund managers and exempt market dealers.

The comments in this letter represent the personal views of the undersigned lawyers and are not necessarily the views of AUM Law. This comment letter is submitted without prejudice to any position that has or may in the future be taken by AUM Law on its own behalf or on behalf of its clients.

We believe the Proposed Rules are a welcome development in the expansion of access to the alternative fund market for retail investors. In particular, we support the CSA's goal of streamlining and modernizing the rules applicable to investment funds (specifically with respect to the form of alternative fund disclosure documents), as well as the streamlining of proficiency requirements for mutual fund dealers.

We are concerned, however, that certain of the proposed amendments may have unintended effects. In particular, we have questions and comments regarding the following issues.

1. Leverage Limits

Though we are supportive of the permitted use of additional leverage by alternative funds under the Proposed Rules, we have some specific concerns that have been raised to us by clients in relation to certain strategies.

The Proposed Rules would regulate alternative funds with a broad spectrum of strategies and risk profiles. The leverage restrictions in the Proposed Rules, however, appear to some to favour equity strategies that rely on the use of derivatives for leverage over managers using fixed-income or debt strategies. In particular, the Proposed Rules require:

A. that the aggregate gross exposure by an alternative fund or a non-redeemable investment fund, through borrowing, short-selling or the use of specified derivatives cannot exceed three (3) times the fund's net asset value (the "**NAV**"). This would be the aggregate of (a) the total amount of outstanding cash borrowed + (b) the combined market value of securities it sells short, and (c) the aggregate notional amount of its specified derivatives positions, including those used for hedging purposes;

B. that alternative funds limit borrowing up to 50% of their NAV; and

C. that the combined use of short-selling and cash borrowing by alternative funds be subject to an overall limit of 50% of NAV.

As a result, an alternative fund could use specified derivatives up to 300% of its NAV whereas an alternative fund that only borrowed cash and utilized short selling could leverage itself up to only 50% of its NAV. The Proposed Rules appear to some to restrict strategies that rely on cash borrowing and short-selling for leverage and favour strategies reliant on derivatives, the implication being that strategies reliant on borrowing cash and short selling are inherently riskier than those using derivatives for leverage.

As a consequence, investment fund managers may be forced to use riskier forms of leverage for funds with strategies that would typically rely on more than 50% of NAV. Some alternative funds sold to retail investors which can abide by the Proposed Rules may thus have inherently risker profiles than an alternative fund which was allowed to borrow cash or short-sell in excess of 50% of their NAV, as a fund manager may utilise riskier derivatives or instruments that they would not otherwise choose to use.

One potential solution is to consider the risk classification of the alternative fund. The CSA could permit two different tiers of restrictions using the new *CSA Mutual Fund Risk Classification Methodology for the Use in Fund Facts and ETF Facts*. A lower leverage restriction could be set for alternative funds rated "Medium to High" or "High", which may include some equity strategies dependant on the use of derivatives. Alternative funds ranked "Low," "Low to Medium" or "Medium," which could include those with credit strategies that rely on short-selling and cash borrowing and deal in securities that are not high-risk in terms of price fluctuation, could be permitted additional leverage.

As risk associated with leverage varies across asset class, this should be reflected in the Proposed Rules. A hard leverage limit, as set out in the Proposed Rules, does not provide investors with a clear and complete understanding of risk associated with leverage and may limit the types of alternative fund strategies that are available for retail investors. As noted above, we suggest that that CSA include a requirement for explicit disclosure of why the particular leverage "tier" is applicable.

2. Exclusions from Leverage Calculation

We propose that the CSA consider carving out specified derivatives and short sales used for hedging purposes from the 300% aggregate leverage calculation for alternative funds. It seems inaccurate to classify these instruments as "leverage" when they are used for hedging, as hedges are generally intended to reduce the overall risk in the portfolio.

We understand the CSA has previously considered this issue, but as it remains an area of concern for a number of alternative portfolio managers, we request that the CSA give the issue further consideration.

3. Counterparty Requirements

The Proposed Rules require an alternative fund to limit its mark-to-market exposure with any one counterparty to 10% of NAV. The Proposed Rules also exempt an alternative fund from the prohibitions that commodity pools are currently subject to under NI 81-104. This prohibition prevents such funds from entering into certain derivative transactions where either the derivative itself, or the counterparty (or the counterparty's guarantor), does not have a "designated rating" as defined in NI 81-102.

We understand that this proposed exemption is intended to facilitate access to more counterparties in order to accommodate the new proposed counterparty requirements. However, the proposed counterparty requirements may nevertheless be too administratively cumbersome and costly for certain alternative funds.

For example, we have been informed that a borrowing agent typically requires that the proceeds from a short sale, plus additional collateral, be held by the borrowing agent as security. Therefore, an alternative fund that wishes to take full advantage of the proposed limit of short selling up to 50% of its NAV would have to contract with six or more borrowing agents to maintain a 10% maximum with each. This could lead to operational and administrative inefficiencies and an increase in the operational costs of the fund.

As the counterparty requirements for alternative funds may be disproportionately restrictive and costly for alternative funds that rely on a strategy of short-selling securities, we ask that the CSA give further consideration to these requirements.

4. Borrowing

The proposed changes to subsection 2.6(2)(a) of NI 81-102 state that "the alternative fund or non-redeemable investment fund may only borrow from an entity described in section 6.2". Although it is implied from the surrounding language that this section relates to "cash borrowing," and not the borrowing of securities in connection with a short sale, if this is the intention then we request that this subsection be clarified to state that the alternative fund ".... may only borrow **cash** from an entity..."

We thank you for the opportunity to comment on the Proposed Rules. Please do not hesitate to contact any of the undersigned should you have any questions or wish to discuss our comments further.

Sincerely,

AUM LAW PROFESSIONAL CORPORATION

Kimberly Poster
Chief Legal Counsel and
Senior Vice President

Cc: Erez Blumberger, President
Jennifer Cantwell, Head of Knowledge Management & Privacy
Sandy Psarras, Senior Legal Counsel

December 22, 2016

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

Delivered to:

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Me. Anne-Marie Beaudoin
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consultation-en-cours@lautorite.qc.ca

Dear Sirs/Mesdames:

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

This comment letter is submitted by Vision Capital Corporation ("Vision" or "we") to provide comments to you on the legislation referred to above.

About Vision

Vision, Toronto-based and a member of AIMA Canada, is a registered dealer in the category of exempt market dealer and a registered investment fund manager under the securities laws of the provinces of Ontario, British Columbia, Alberta, Manitoba and Quebec and a registered adviser in the category of portfolio manager in the provinces of Ontario, British Columbia, Alberta and Manitoba. Vision is the manager of Vision Opportunity Fund Trust, Vision Opportunity Fund Limited Partnership, Vision Opportunity Non-Resident Fund Limited Partnership and Vision Strategic Opportunity Fund Limited Partnership.

Comments

The comments submitted herein are in addition to what is being concurrently submitted by AIMA Canada in its comment letter on the behalf of its members (the "AIMA Letter"). Vision believes the AIMA Letter is well written, reasonably comprehensive and thoughtful, and Vision is supportive of the recommendations being put forth on behalf of AIMA Canada's members.

Vision believes that of greatest importance are AIMA Canada's recommendations to certain proposed amendments that are critical from a practical perspective in order for the modernization of investment funds to achieve the goals for which it was intended. The following table highlights these questions and AIMA Canada responses.

CSA Questions/Comments	**AIMA Canada Responses / Recommendations (Summarized)**
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.	*While not a separate asset class, market neutral strategies should be eligible to be offered as alternative funds, which would not be possible under the Proposed Amendments limiting the maximum short position to 50% of NAV.*
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.	*Mismatching of the Issue and Redemption Prices and NAV Calculations. Matching the calculation of NAV to the redemption and purchase frequency of the alternative funds needs to considered and implemented to avoid significant inefficiencies and confusion.*
Custodians of Alternative Funds (Part 6 of NI 81-102) – Proposed Amendments would require alternative funds to appoint custodian for the assets of the fund in the same manner as conventional mutual.	*Permitting prime brokers of alternative funds to also act as custodian of the alternative funds as the requirement to have a separate custodian for the assets does not provide any significant additional safeguards and would result in increased costs and operational complexities for alternative funds.*
Custodial provisions relating to short sales (Section 6.8.1) – Currently permits funds to deposit up to 10% of NAV with a borrowing agent, other than its custodian, as security in connection with a short sale.	*Permitting prime brokers of alternative funds to also act as custodian of the alternative funds would allow the current language in Section 6.8.1 to function more effectively.*
Presentations of Financial Highlights in NI 81-106 – Currently requires long and short returns to be calculated separately.	*Exemption for alternative funds to have long and short returns be calculated separately as a core fundamental component of many alternative funds involves the execution of long-short paired trades. As such, the trade itself is only relevant by considering the combination of the long and short components.*

Historical Performance Record (Part 15 of NI 81-102) – Section 15.6(1)(a) contains prohibition against the inclusion of performance data in sales communications for a mutual fund that has been distributing securities under a prospectus for less than 12 consecutive months.	*Exemption from the prohibition contained in NI 81-102 to permit alternative funds that convert from pooled funds to include their historical performance data in sales communications with appropriate qualifications to allow investors to obtain complete picture of the alternative fund manager.*

The aforementioned questions/comments and corresponding responses/recommendations are particularly critical and without their serious consideration and implementation by the CSA, Vision believes that the proposed amendments as they are currently drafted will have, on balance, negative impact to the Canadian investment community as a whole. As the AIMA Letter highlights, the vast majority of AIMA Canada members are small managers of alternative investment funds. While Vision's assets under management position us as one of the larger alternative fund managers amongst AIMA Canada members, we remain quite concerned with these implications. The operational and cost implications of the CSA not agreeing with the requested recommendations as submitted by AIMA Canada, would be prohibitive for the majority of the small fund managers to contemplate providing alternative funds to retail investors in Canada. Accordingly, it will only be the largest institutions such as the Canadian banks, large mutual fund companies, etc. that have the capital and the resources to benefit from the proposed amendments as currently drafted. This could potentially, for competitive reasons, result in a further hollowing out in the Canadian financial services industry and result in anti-competitive behaviour and be a detriment to the vast majority of the AIMA Canada members who are the small fund managers. There is large body of research and analytical reports that demonstrate that smaller investment managers and sector specialists generate superior risk –adjusted performance relative to large and more generalist funds. It would seem prudent and responsible for the CSA to ensure that any such well-qualified funds bolstered with strong operational and compliance infrastructure can practically and effectively contemplate product offerings to benefit Canadian investors.

Conclusion

While Vision is supportive of including a broad choice of possible investment products to Canadian investors, it wants to ensure that the Proposed Amendments offered under NI 81-102 will preserve a level playing field for all market participants, whether big or small.

We appreciate the opportunity to provide the CSA with its views on the Proposed Amendments. Please do not hesitate to contact the undersigned with any comments or questions you may have.

Yours sincerely,

VISION CAPITAL CORPORATION

Jeffrey Olin
President and CEO
(416) 362-6546
olin@visioncap.ca

INCLUDES COMMENT LETTERS

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December 22, 2016

VIA E-MAIL

British Columbia Securities Commission
Alberta Securities Commission
Financial and Consumer Affairs Authority of Saskatchewan
The Manitoba Securities Commission
Ontario Securities Commission
Autorité des marchés financiers
Financial and Consumer Services Commissioner (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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Me Anne-Marie Beaudoin
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consultation-en-cours@lautorite.qc.ca

Dear Sirs/Mesdames:

Re: CSA Notice (the "Notice") and Request for Comment *Modernization of Investment Fund Product Regulations – Alternative Funds* (the "Alternative Funds Proposal")

We are writing in respect of the request for comments dated September 22, 2016 regarding the Alternative Funds Proposal. We appreciate the opportunity to comment on these important matters.

Invesco Canada Ltd. is a wholly-owned subsidiary of Invesco, Ltd. Invesco is a leading independent global investment management company, dedicated to helping people worldwide build their financial security. As of November 30, 2016, Invesco and its operating subsidiaries had assets under management of approximately US$805 billion. Invesco operates in 20 countries in North America, Europe and Asia.

Invesco Canada is registered as an Investment Fund Manager, an Adviser and a Dealer in Ontario and certain other provinces. Our investment products are primarily bought by and sold to retail investors and institutional investors. As such, we take a great interest in regulatory discussions that impact those investors.

Over the last several years, the Canadian Securities Administrators (the "CSA") has undertaken a review of National Instrument 81-102 *Investment Funds* ("NI 81-102") under the guise of "modernization". We applaud these efforts and have largely been supportive of these efforts and the Alternative Funds Proposal is no different. Overall, we believe that the Alternative Funds Proposal is a good, although imperfect, proposal that is good for Canadians. We will not address the importance of alternative investment fund products in a properly diversified client portfolio as it is clear that the CSA understands this. We welcome the CSA's evolution in thinking in this area and note that the Alternative Funds Proposal will allow Canadian fund manufacturers and their clients to catch up to the rest of the world with respect to alternative investment fund products.

We note that similar initiatives (at least insofar as derivatives and leverage are concerned) have been carried out in Europe and are underway in the U.S. although, in each case, the scope of products for which the initiatives are attached may differ slightly. The common thread through these proposals is the total leverage limit. Overall, we believe the major issue to be addressed with the Alternative Funds Proposal is the total leverage limit and, so, we will begin our comments with that – in the framework of the questions posed in the Notice – and then answer selected other questions from Appendix A.

Total Leverage Limit

Question 9

In response to the CSA's question 9 in Appendix A, in our opinion the proposed leverage limits would make it very difficult and in some cases impossible to offer in Canada, under NI 81-102, global macro strategies, managed futures strategies and many risk parity and unconstrained bond strategies, all of which depend on derivatives. We note that Canadian retail investors generally have less access to risk-managing products than investors in other countries due to the derivatives rules in NI 81-102.

Question 10

In response to the CSA's question 10, our greatest concern with the Alternative Funds Proposal is what we perceive to be the mistreatment of leverage. In this sense, the Alternative Funds Proposal is almost identical to the initial draft of Proposed Rule 18f-4 (the "US Proposal") published by the Securities and Exchange Commission in the United States (the "SEC"). The fund management industry was heavily critical of the requirement to use gross notional amount for derivatives in the leverage calculation. In a comment letter filed with the SEC by our affiliate Invesco Advisers, Inc. (the "US Comment Letter"), Invesco stated:

> "A leverage limit based on gross notional exposure is inherently flawed because greater economic leverage does not necessarily mean greater risk. Simply summing the notional amount of a fund's derivative investments provides a distorted picture of risk because it disregards the effects of any hedging or risk-mitigating derivatives transactions. Consequently, the [US Proposal's] general limits on a fund's gross notional exposure across all derivative instruments will not serve to limit risk and volatility uniformly across all funds that invest in derivative instruments. As the [SEC] explained in the [US Proposal], the risk and volatility profile of two different derivative instruments, both with the same notional amount, may be vastly different....So although a leverage limited based on notional amounts has an ostensible benefit in terms of simplicity, it has an associated cost: it treats all of a fund's derivatives transactions as though they were the one-way speculative directional bets made by funds in the [US Proposal's] case studies."

We note that as a result of our comments and those of other industry peers and trade associations, the SEC is re-considering this aspect of the US Proposal and is actively considering haircuts on notional amounts based on relative risk. We believe the CSA should engage with the SEC on this matter, given the SEC's relative expertise in this area and its experience through its own rule-making process. For your consideration, we attach as Appendix 1 a memorandum dated November 1, 2016 issued by the Division of Economic and Risk Analysis ("DERA") of the SEC analyzing the industry's proposals in that regard. While the DERA does not provide a recommendation, it is clear from their memorandum that there is much merit to the industry proposal and that it addressed the industry's concerns – which are virtually identical in Canada – in a manner that satisfies regulatory objectives.

In our view, the foregoing applies equally to the total leverage calculation contained in the Alternative Funds Proposal.

Returning to the specifics of the Alternative Funds Proposal, under proposed section 2.9.1, an investment fund's aggregate gross exposure, or leverage, must not exceed 3 times the investment fund's net asset value. The aggregate gross exposure calculation under subsection 2.9.1(2) is as follows:

(a) Aggregate value of the fund's indebtedness under any borrowing agreements; PLUS

(b) Aggregate market value of securities sold short by the fund; PLUS

(c) The aggregate notional amount of the investment fund's specified derivatives positions.

Based on the Notice, we understand that aggregate notional amount was selected due to simplicity (much as the SEC did). Unfortunately, while simple, it likely renders the new section ineffective as discussed above. Furthermore, while simple, it betrays a misunderstanding of derivatives and of global derivatives markets generally. It is important that Canada be consistent with the rest of the world in this regard due to the global nature of derivatives trading and the increasing reality that derivatives do not know national borders. From a fiduciary perspective, we want to get the best derivatives deal for our funds when we use derivatives but the complexities and uniqueness of NI 81-102 derivatives requirements often results in funds being constrained to use Canadian counterparties which, by definition, is a smaller market than the market for global counterparties. Global counterparties are more interested in business that is scalable which requires some similarity in rules. For a smaller market like Canada, if our rules are too dissimilar to those of the US or Europe, it simply becomes inefficient for non-Canadian counterparties to deal with Canadian investment funds and this results in higher spreads charged by Canadian counterparties. It seems obvious to us that this is simply a bad result for Canadian investors and regulation should not be the driver of higher costs to investors where there is no discernible benefit to incurring that cost or there are less costly means of achieving the same purpose.

Using aggregate notional amount in the leverage calculation does not reflect the commercial reality of the fund's exposure. Assume you have a $100 million fund that invests in only U.S. equities. The fund follows a hedging policy and hedges all of its exposure. Therefore, the notional amount of derivatives for that fund will be $100 million. But it does not really have $100 million at risk if the transaction is subject to netting and set-off provisions which is fairly commonplace. Its amount at risk is limited to the mark-to-market appreciation of its derivatives position or, in other words, its "exposure" as that term is used in subsection 2.7(4) of NI 81-102. It is not clear, therefore, why anything beyond exposure would be relevant for leverage calculation purposes.

Another way to look at this is using the example of a U.S. equity fund that fully hedges its U.S. dollar (USD) exposure to the Canadian dollar (CAD). If the Canadian and U.S. dollar are at par and remain as such, there would be no payment under the derivative and there would be no liability. Theoretically, the fund would owe the counterparty CAD 100 million and the counterparty would own the fund USD 100 million. Since in this example 1 USD = 1 CAD, the payments would be netted and no payment would be made, including in bankruptcy. Under proposed s.2.9.1, however, the fund would be considered to have 1 times leverage. As that leverage amount would be disclosed to investors under the Alternative Fund Proposal, the investor would be grossly misled.

It is not entirely clear why the CSA has chosen gross notional amount for this calculation. It appears to us that the CSA is equating the gross notional amount of a derivative with an outstanding amount of indebtedness in the sense that if the fund has a debt of $1 million outstanding, it is possible that the fund could be required to pay $1 million more than it has in assets which could, theoretically, lead the fund to "call" investors to put up more funds. This is contrary to the notion of mutual fund investing where your investment is the amount at risk. However, $1 million notional of derivatives does not have this same effect as long as proper documentation has been agreed by the parties to the transaction. Historically this was not always required in that not all derivatives transactions were subject to an ISDA agreement or other agreement with netting provisions; such is no longer the case as a result of the panoply of reforms to derivatives rules following the Global Financial Crisis in 2008-2009. Rather, the same effect is seen through the fund's "exposure" and that ought to properly be the input into the leverage calculation.

The difference between conventional mutual funds and alternative funds from an investor risk perspective is the risk of loss of capital and the general view that there is a greater likelihood of such risk in an alternative fund due either to illiquidity of underlying assets or through the use of derivatives. While we do not concede the validity of this concern, we note that what is important is ensuring that the potential loss for an investor is not more than their investment, i.e. there should never be a situation where the fund or a creditor has any recourse to an investor in a fund. In our view, therefore, this can be achieved by ensuring the aggregate exposure of derivative positions does not exceed 100% of NAV. By revising subsection 2.7(4) in this manner for alternative funds, the overall leverage ratio is simply not necessary. We note that under our alternative proposal, excess leverage beyond these amounts would still be permitted although an issuer could only do so through an offering memorandum and exempt distribution.

Another possible approach is to exclude from the gross notional amount used in the calculation, derivatives used for hedging purposes (which clearly are not used to lever the portfolio). While we do not believe that the total leverage limit is necessary at all given collateralization requirements and the widespread use of ISDA agreements, we would not object to such a limit if only the gross notional amount of speculative and/or non-collaterialized derivatives is used in the calculation. This would reinforce that the regulatory concern is the loss of investor capital for an amount greater than the investor's investment. At a minimum, derivatives used for hedging purposes must be excluded from the calculation.

The current definition of hedging is difficult to administer under the simplified approach to derivatives taken by many Canadian mutual funds. The major problem is clause (ii) of the definition as certain hedges are not simply correlation hedges, such as interest rate swaps. In our opinion, clauses (i) and (iii) together constitute an appropriate definition of hedging and if such were the definition in NI 81-102, it would be fairly simply to draft the proper exclusionary language for use in the calculation of the leverage limit. We note that the investment fund manager or portfolio manager, as the case may be, would still be obliged to prove to CSA members that that transaction is a hedge if scrutinized, but it would allow the flexibility to include hedges that are not direct offsets such as a currency hedge.

Question 11

In response to the CSA's question 11 in Appendix A, we believe there are many options that the CSA should consider.

As noted above, the CSA could retain the leverage ratio but replace notional amount with exposure for purposes of the calculation. This approach is consistent with the underlying concern – risk of loss – and is also consistent with the counterparty concentration limit in s.2.7(4) of NI 81-102 and is simple to calculate and monitor.

Alternatively, the CSA could proceed with the proposed leverage limits using notional amounts but with risk-based offsets in the calculation. This is the concept discussed by DERA in Appendix 1.

In the further alternative, the CSA could adopt a Value at Risk approach (combined with stress testing) which measures the maximum potential loss at a given confidence level over a specific timer period under normal market conditions. To this end, we quote at length from our US Comment Letter:

> If the Commission determines it must impose leverage limitations directly, Invesco believes that the Commission should adopt a risk-based metric coupled with stress testing and enhanced derivatives disclosures in lieu of imposing arbitrary leverage limits based on gross notional exposure. A VaR metric measures the maximum potential loss at a given confidence level (i.e., probability) over a specific time period under normal market conditions.
>
> Under the UCITS regime, a fund may use either a relative VaR or an absolute VaR approach. Under the relative VaR approach, the VaR of the UCITS fund's portfolio cannot be greater than twice the VaR of an unleveraged benchmark securities index.[1] Under an absolute VaR approach, a UCITS fund is limited to a VaR that is no greater than 20% of the UCITS fund's net assets (calculated using a 99% confidence level and a holding period of 20 days which is consistent with many regulatory schemes that use VaR).[2] The absolute VaR's 20% maximum limit was intended as a balanced approach, high enough to permit prudent risk taking yet low enough to provide 'guardrails' to prevent excessive market risk by UCITS funds.[3] Consistent with the UCITS approach,

[1] Id. at 124.

[2] Id. at 125, 138 and 141.

[3] See Feedback Statement on Committee of European Securities Regulators (CESR) Guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS, Ref.: CESR/10-798 (July28, 2010), at 13-14 (in providing feedback on the responses received to the consultation on CESR's Guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS, the CESR noted that, while respondents recommended that the calculation standards proposed for the VaR approach should be as high as between a 30% and 50%, the CESR determined that an appropriate maximum limit for the absolute VaR approach is not greater than 20%).

Invesco advocates allowing a fund to determine whether the relative VaR or absolute VaR approach is appropriate for a fund based on the fund's investment strategy.[4]

Firms and regulators across the globe acknowledge the benefits of the VaR metric. As the Commission noted as early as 1997 in its proposed release for capital and margin requirements for OTC derivatives dealers, many firms use VaR modeling to analyze, control and report their level of market risk. Various U.S. and global regulators also use VaR as a common risk measurement system and a minimum standard for capital adequacy of banks.[5] The primary benefits of VaR for investment advisers include facilitating consistent and regular monitoring of market risk and monitoring the extent to which hedging strategies are accomplishing their desired objectives.[6] In addition, VaR models can be compared across different markets and different exposures, are a universal metric that applies to all activities and to all types of risk, and can be measured at any level, from an individual trade or portfolio, up to a single enterprise-wide VaR measure covering all the risks in the firm as a whole.[7] When aggregated (to find the total VaR of larger portfolios) or disaggregated (to isolate component risks corresponding to different types of risk factors), VaR takes into account dependencies between the constituent assets or portfolios.[8] For these reasons, VaR analysis has become the standard risk management tool among many global firms and regulators. We therefore recommend that the Commission adopt a VaR approach similar to the UCITS guidelines for purposes of imposing limits on the amount of leverage a fund may obtain through the use of derivative instruments.

Invesco notes that many U.S. investment advisers offer products in the European markets, including UCITS funds subject to the VaR requirements (in particular, the relative VaR approach and the absolute VaR approach, as applicable). Adopting a VaR approach not only effectively limits potentially conflicting regulatory regimes for such firms but has the added benefit of enabling such firms to leverage existing infrastructure used by those UCITS funds to satisfy the risk limits applicable to the UCITS funds.

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[4] See, for example, the UCITS guidelines which provide that the relative VaR approach should be used by a fund employing investment strategies with a leverage-free benchmark whereas in contrast, the absolute VaR approach would be more suitable for a fund that invests in multiple asset classes and that defines its investment target in relation to an absolute return target, rather than to a benchmark.

[5] See Securities Exchange Act Release 34-39454 (December 17, 1997), at 33-34 ("Rules adopted recently by the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation (collectively, the "U.S. Banking Agencies") were designed to implement the [Basel Accord] for U.S. banks and bank holding companies. Appendix F [of this Release] is generally consistent with the U.S. Banking Agencies' rules, and incorporates the quantitative and qualitative conditions imposed on banking institutions.").

[6] Value at Risk for Asset Managers, Christopher L. Culp, Ron Mensink, CFA, and Andrea M.P. Neves, Derivatives Quarterly, Vol. 5, No. 2 (Winter 1998), at 28-29.

[7] Market Risk Analysis Volume IV: Value-at-Risk Models by Carol Alexander (2009), available at https://www.safaribooksonline.com/library/view/market-risk-analysis/9780470997888/11_chapter001.html

[8] Id.

ii. Applying Stress Testing as a Complement to VaR Analysis Addresses the Commission's Concerns Regarding the Shortcomings of VaR Analysis

Use of a VaR metric as a risk measurement and framework for leverage limits, coupled with stress-testing which is consistent with UCITS guidelines, fully addresses both the Commission's stated goals under the Proposal and the Commission's concerns regarding the use of the VaR approach. The Commission has expressed its concern that VaR cannot incorporate all possible risk outcomes, notably "tail risk."[9] However, as the Commission also noted, "stress testing is used increasingly as a complement to the more standard statistical models used for VaR analysis."[10] Stress testing serves as a valuable complement to VaR analysis and it directly addresses the Commission's reservations about a VaR approach.

Stress-testing provides risk managers with a clear idea of the vulnerability of a defined portfolio and measures the potential loss that may be suffered in a hypothetical scenario of crisis.[11] Complementing a VaR approach with ongoing stress testing requirements addresses the Commission's stated concerns about "tail risk" and VaR's dependence on the historical trading conditions during the measurement period, which may dramatically change between stressed conditions and benign trading conditions.

Regulators and a large segment of the investment management industry have also developed stress testing tools for their own monitoring purposes.[12] Stress testing plays an important role in Invesco's risk management and in all stages of Invesco funds' investment process, including risk allocation, internal limit setting and hedging, for our

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[9] Proposal at 126-127; compare Proposal at 346 ("[the Commission's] concern with respect to an absolute VaR method is that the calculation of VaR on a historical basis is highly dependent on the historical trading conditions during the measurement period and can change dramatically both from year to year and from periods of benign trading conditions to periods of stressed market conditions").

[10] Federal Reserve Bank of San Francisco Economic Letter at 1; see also, Invest. Mgmt. and Financial Innovations Paper, at 72 ("In general, the Stress-Testing exercise always implies a higher level of risk measured in terms of VaR").

[11] Applying Stress-Testing On Value at Risk (VaR) Methodologies, Investment Management and Financial Innovations, José Manuel Feria Domínguez, María Dolores Oliver Alfonso (April 2004), at 62, available at http://businessperspectives.org/journals_free/imfi/2004/imfi_en_2004_04_Dominguez.pdf; see also, Stress Testing in the Investment Process, Ruban, Oleg A. and Melas, Dimitris and MSCI Inc. (August 3, 2010), at 2 ("Stress tests explore the tails of the loss distribution by looking at the extent of potential large portfolio losses and possible scenarios in which these losses can occur. Stress tests help identify and manage situations that can result in extreme losses."), available at http://dx.doi.org/10.2139/ssrn.1708243

[12] See, e.g., Federal Reserve Bank of San Francisco Economic Letter at 2-3 ("the Federal Deposit Insurance Corporation uses a stress-testing model to identify depository institutions that are potentially vulnerable to real estate markets. The model is calibrated to the New England real estate crisis of the early 1990s, which caused the closure of several depository institutions. With regard to interest rate risk, the Federal Reserve System maintains a duration-based valuation model that examines the impact of a 200-basis-point increase in rates on bank portfolio values. (internal citation omitted) The model can be used to detect banks that would appear to be the most vulnerable to rising interest rates.").

U.S. registered investment company products, among other investment products. Broadly speaking, risk managers can develop a stress-testing exercise in various ways:

> *Historical Scenarios of Crisis*: Scenarios are chosen from historical disasters such as the US stock market crash of October 1987, the bond price falls of 1994, the Mexican crisis of 1994, the Asian crisis of 1997, the Argentinean crisis of 2001, financial crisis of 2007 - 2009, etc.
>
> *Stylized Scenarios*: Simulations of the effects of some market movements in interest rates, exchange rates, stock prices and commodity prices on the portfolio. These movements are expressed in terms of both absolute and relative changes, such as:
>
> - Parallel yield curve in ±100 basis points
> - Stock index changes of ±20%
> - Currency changes of ±10%
> - Commodity changes of ±40%
> - Volatility changes of ±20%

Hypothetical Events: A reflection process in which we consider the potential consequences of certain hypothetical situations such as an earthquake, an international war, a terrorist attack, etc.[13]

The key advantage of stress tests under scenarios (such as the three above) is that they link a loss to a specific event, which can be more meaningful to portfolio managers than a summary statistic of the loss distribution.[14] Under the UCITS guidelines, a fund that uses the VaR approach should design its risk management process to include a rigorous, comprehensive and risk adequate stress-testing program. The stress-testing program should be designed to measure any potential major depreciation of the UCITS fund's value as a result of unexpected changes in the relevant market parameters and correlation factors.

Similarly, the Commission could prescribe various historical periods and various prescribed shocks, such as the shocks indicated under the above "Stylized Scenarios" and investment advisers could, where necessary and based upon the results of the stress-testing, make appropriate portfolio adjustments. Indeed, VaR used in isolation as

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[13] Applying Stress-Testing On Value at Risk (VaR) Methodologies, Investment Management and Financial Innovations ("Invest. Mgmt. and Financial Innovations Paper"), José Manuel Feria Domínguez, María Dolores Oliver Alfonso (April 2004), at 62-63, available at http://businessperspectives.org/journals_free/imfi/2004/imfi_en_2004_04_Dominguez.pdf

[14] Stress Testing in the Investment Process, Ruban, Oleg A. and Melas, Dimitris and MSCI Inc. (August 3, 2010), at 2, available at http://dx.doi.org/10.2139/ssrn.1708243

a risk metric could be limiting, as the Commission observed.[15] This is why "stress-testing is used increasingly as a complement to the more standard statistical models used for VaR analysis."[16] Accordingly, use of a VaR metric as a risk measurement and framework for leverage limits, coupled with stress-testing which is consistent with UCITS guidelines, fully addresses both the Commission's stated goals under the Proposal and the Commission's concerns regarding the use of the VaR approach.

By opting for simplicity over these alternatives, the CSA risks exhibiting a lack of understanding of derivatives, how they work, and the risks to which they give rise. Given the nature of derivatives trading and the volumes in other countries, it is not clear why the CSA feels the need for Canada to come up with yet another approach that does not align with the rest of the world. We find it odd that in the recent CSA Consultation Paper 33-404, one of the reasons for proceeding with those proposals was that, internationally, "best interests standard" is the way regulators are moving. While we did not agree with that as a rationale for proposals relating to a best interests standard, we do think it is wrong to ignore international developments without a full understanding of them. We note that the U.S. and Europe, as compared to Canada, are clear leaders in derivatives trading and we should take advantage of the thought leadership offered by those jurisdictions.

Concentration Limits

In response to the CSA's question 3 in Appendix A of the Notice, while satisfied with a 20% concentration limit, we would prefer a limit of 25% which is consistent with the asset diversification requirements of the U.S. tax code and U.S. practice. For firms that operate in both countries, the benefits of this type of consistency is that the same strategies can be run for clients in both countries and sometimes through the same investment pool (subject to discretionary relief) which creates scale. We are all aware that investment fund fees are a major issue for regulators and we observe that increased scale creates a more likely set of conditions under which a mutual fund manager might reduce management fees.

We do not support the adoption of a hard cap as is currently the case for investments in illiquid assets. From a philosophical perspective, it is not clear what the hard cap offers. If the same approach is followed for illiquid assets, then the hard cap would presumably be 25%, implying that a fund can have investments in as few as 4 issuers, rather than the 5 issuers implied by a 20% cap. The benefit of the additional issuer from a diversification perspective is negligible and, as such, the additional limit does not materially impact investor protection yet it entails an additional item to monitor for compliance, which itself entails a cost. Clearly the underlying philosophy for this aspect of the Alternative Funds Proposal is that excessive concentration is fine. Once that philosophical issue has been resolved, further limits cannot really be justified. As such, we oppose an absolute cap on portfolio concentration.

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[15] See footnote 9, *supra*.

[16] Federal Reserve Bank of San Francisco Economic Letter at 1; see also, Invest. Mgmt. and Financial Innovations Paper, at 72 ("In general, the Stress-Testing exercise always implies a higher level of risk measured in terms of VaR").

Limit on Illiquid Assets

In response to the CSA's question 4 in Appendix A of the Notice, we agree that there should not be a higher limit on illiquid assets for alternative funds. In our opinion, limits on illiquid assets are necessary for a product that offers daily liquidity and there is no reason to believe that liquidity needs of alternative funds are different from those of mutual funds.

In response to the CSA's question 5 in Appendix A of the Notice, while we do not have any suggestions, we would note that if liquidity is other than daily, then the amount of liquidity need not be as high as if it were daily. If the alternative fund can choose their liquidity terms, those with less liquidity should have higher limits on illiquid assets.

In response to the CSA's question 6 in Appendix A of the Notice, we do not agree that non-redeemable investment funds should have a limit on illiquid assets since these funds are, by definition, non-redeemable. We understand that illiquid asset limits are necessary to ensure that a conventional mutual fund is able to meet liquidity demands. This issue simply does not arise for non-redeemable investment funds.

In response to the CSA's question 7 in Appendix A, please refer to our response above regarding question 5 as it is the same issue.

We trust that are comments are helpful. We would be pleased to discuss our comments further should you so desire.

Yours very truly,

Invesco Canada Ltd.

Eric Adelson
Senior Vice President, Head of Legal – Canada

MEMORANDUM

To: File S7-24-15, Use of Derivatives by Registered Investment Companies and Business Development Companies

From: The Division of Economic and Risk Analysis[1]

Date: November 1, 2016

Re: Risk Adjustment and Haircut Schedules

Many commenters on proposed rule 18f-4 suggested that the rule should measure a fund's derivatives exposure using notional amounts adjusted to reflect the risks of the underlying reference assets. These commenters suggested that the Commission adopt risk-based adjustments derived from standardized schedules used for other regulatory purposes. Many commenters also suggested that a fund be permitted to maintain as qualifying coverage assets a range of assets in addition to cash and cash equivalents, subject to "haircuts" to the value of these additional assets identified in standardized schedules included in other regulatory requirements. In light of these comments, DERA staff analyzed the regulatory requirements most frequently identified by commenters.

This memorandum sets out the methods by which DERA staff performed its analysis and the results thereof. The Commission has expressed no view regarding any specific risk-based adjustments, or our analysis or its results.

1. Summary of Existing Schedules on Margin Requirements

First, we summarize the standardized schedules most frequently identified by commenters and which commenters suggested could be used to derive risk-based adjustments to notional amounts for purposes of rule 18f-4[2]: the schedules used in the final rules for margin requirements for uncleared swaps adopted by the prudential regulators and the Commodity Futures Trading Commission (PR and CFTC, respectively).[3] These schedules are consistent with the schedule

[1] This is a memo by the Staff of the Division of Economic and Risk Analysis of the U.S. Securities and Exchange Commission. The Commission has expressed no view regarding the analysis, findings or conclusions contained herein.

[2] *See, e.g.*, Comment Letter of the Investment Company Institute (July 28, 2016), *available at* https://www.sec.gov/comments/s7-24-15/s72415-244.pdf ("ICI July 28, 2016 Comment Letter") (proposing a schedule based on the PR/CFTC schedule) ; Comment Letter of the Investment Adviser Association (Aug. 18, 2016), *available at* https://www.sec.gov/comments/s7-24-15/s72415-250.pdf (while opposing portfolio limitations entirely, supporting the PR/CFTC-based schedule provided by the ICI); Comment Letter of James A. Overdahl, Delta Strategy Group (Mar. 24, 2016), *available at* https://www.sec.gov/comments/s7-24-15/s72415-85.pdf (suggesting the PR schedule as one possibility).

[3] Margin and Capital Requirements for Covered Swap Entities, 80 FR 74839 (Nov. 30, 2015), *available at* https://federalregister.gov/a/2015-28671; Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 81 FR 635 (Jan. 6, 2016), *available at* https://federalregister.gov/a/2015-32320.

for the margin requirements for non-centrally cleared derivatives published by the Bank for International Settlements (BIS), which some commenters also suggested could form a basis for adjustments to notional amounts for purposes of rule 18f-4, and so we analyze all three schedules (collectively, the "regulatory schedules") together.[4]

These sources generally provide standard margin schedules organized by reference asset class, including the asset classes most frequently discussed by commenters.[5]

Table 1. Summary of PR/CFTC/BIS Schedules

Asset Class	*Initial Margin Requirement*[a]
Credit: 0–2y duration	2%
Credit: 2–5y duration	5%
Credit 5+y duration	10%
Commodity	15%
Equity	15%
Foreign exchange	6%
Interest rate: 0–2y duration	1%
Interest rate: 2–5y duration	2%
Interest rate: 5+y duration	4%

[a] Expressed as % of notional exposure

As depicted in Table 1, the initial margin schedules set by the PR, CFTC, and BIS are identical for all reference asset classes analyzed.

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[4] Basel Committee on Banking Supervision, Board of the International Organization of Securities Commissions (Mar. 2015), *available at* http://www.bis.org/publ/bcbs261.pdf; *see, e.g.*, Comment Letter of the Securities Industry and Financial Market Association (Mar. 28, 2016), *available at* https://www.sec.gov/comments/s7-24-15/s72415-174.pdf (primarily supporting BIS schedule).

[5] We do not analyze specific types of derivatives transactions, and thus do not analyze cross currency swaps, which are included in the PR/CFTC schedules but are not included in the BIS schedule.

2. Risk Analyses and Comparisons

To evaluate commenters' suggestions regarding these standardized schedules, we assess how they relate to the risks of the underlying reference assets. We use the PR and CFTC schedules, and the BIS schedule, as the main reference point because they were most frequently identified by commenters and provide identical values for all of the asset classes analyzed below.[6]

2.1. U.S. Treasury Securities

Commenters suggested two different means of risk-adjusting the notional values for interest rate derivatives. These are discussed below.

2.1.1. Risk Comparisons of the Existing Schedules

Because the regulatory schedules provide that the highest amount of initial margin applies to equity derivatives, the volatility of large capitalization equity securities can be used as a baseline against which to compare the other asset classes in the schedule.[7] To evaluate the suggested risk adjustments for interest rate ("IR") derivatives, we first determine the relative risk of U.S. Treasury securities as compared to domestic large capitalization equity securities. We compute risk levels (*i.e.*, monthly standard deviations) using monthly total returns of the S&P 500 and the Barclays Treasury Series from January 1997 to July 2016, for which we have data available.[8] We then divide the standard deviation of the U.S. Treasury securities by the standard deviation of the S&P 500 to compute the risk ratios. Table 2 summarizes the results.

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[6] The risk analyses performed here are based on indexes rather than individual securities. We believe that the analyses should generally capture the relative risk across various asset classes.

[7] The initial margin requirements in the regulatory schedules are expressed as a percentage of notional amounts, which are subject to additional calculations to determine initial margin amounts to be collected under the applicable regulatory margin requirements. The regulatory schedules provide that the highest amount of initial margin also must be collected for commodity derivatives. A comparison of S&P 500 and two commonly used commodity indexes (the Bloomberg and the S&P GSCI commodity indexes) indicates that commodities have a similar or somewhat higher risk level as compared to equity securities.

[8] To understand whether the risk ratios we calculated would be materially different under different sets of market conditions, including during periods of financial stress, we perform these analyses using data from 2008-2010. We obtain similar findings, which are provided in the appendix. Data for the S&P 500 are obtained from Morningstar. Data for all Treasury and corporate bond series are obtained from Datastream.

Table 2. Risk Analyses for U.S. Treasury vs Equity Securities

	(1)	*(2)*	*(3)*	*(4)*
Asset Class	*Risk Level (standard deviation of historical returns)*	*Initial Margin Requirement under PR/ CFTC/BIS schedules*	*Risk Ratio implied by PR/CFTC/BIS schedules*[a]	*Risk Ratio computed relative to Equity risk level*
Equity	4.45	15%	100%	100%
Treasury IR: 0–2y	0.27[b]	1%	7%	6%
Treasury IR: 2–5y	0.62[c]	2%	13%	14%
Treasury IR: 5+y	2.48[d]	4%	27%	56%

[a] Computed as the initial margin requirement of an asset class divided by the initial margin requirement of equity (15%)
[b] Computed using interest rate of Treasury 0-3 months and 1-2 years
[c] Computed using interest rate of Treasury 1-5 years
[d] Computed using interest rate of Treasury 5-10, 10-20, and 20+ years

Historical risk levels and risk ratios implied by the PR, CFTC, and BIS schedules for equity (S&P 500 as proxy) and various Treasury securities are reported in Columns 1 and 2 of Table 2. The implied risk ratio from the existing regulatory schedules (initial margin of an asset class divided by initial margin requirement for equity) is reported in Column 3. Commenters suggested that these implied risk ratios can be used as the multipliers to calculate risk-adjusted notional amounts for purposes of rule 18f-4.[9] Column 4 reports realized risk ratios calculated by the ratio between the historical volatility of the Treasury series and the historical volatility of the S&P 500.

Comparing columns 3 and 4, we observe that for short-term Treasury securities (2 years or less), the margin schedules are roughly consistent with the underlying risk levels of the reference assets. We compute a risk ratio of 6%, as compared to the 7% implied from the PR, CFTC, and BIS schedules.

For medium-term U.S. Treasury securities, the ratios are also consistent, although due to data availability our series is for 1 to 5 years, rather than 2 to 5 years as in the regulatory schedules.[10,11]

[9] *See supra* footnotes 2 & 4.

[10] Please also note that BIS and CFTC schedules classify interest rate derivatives using duration rather than maturity. For most U.S. Treasury securities (up to 10 years), durations are fairly close to actual maturities (*e.g.*, for 1 year U.S. Treasury securities, duration is 0.96; for 5 year U.S. Treasury securities, duration is 4.85). Therefore, using maturity as a substitute for duration in this analysis will have a minimal impact on our comparisons using maturity-based series.

For long-term U.S. Treasury securities with maturities exceeding 5 years, our analyses indicate a higher calculated risk ratio (56%) versus what is implied by the PR, CFTC, and BIS schedules (27%). We note, however, that if long-term U.S. Treasury securities refer to those with mainly 5 to 10 year maturities, our risk analyses yield a risk ratio of 36%, which is closer to these schedules.

2.1.2. Reference Bond

Commenters suggested in the alternative that rule 18f-4 should permit funds to adjust the amount of interest rate derivatives by normalizing them to a specified reference bond. Some commenters suggested that the 10-year Treasury bond would be an appropriate reference bond, whereas others suggested the appropriate reference bond would be the 30-year Treasury bond because these commenters asserted that the 30-year Treasury bond has a level of volatility roughly comparable to that of equity markets.[12]

Using data from 1980 to 2016, we compute the risk levels of these asset classes and find that this methodology suggests that the relative risk level for the 30-year Treasury bond is 86% of the S&P 500, while the relative risk level for the 10-year Treasury bond is 55%.

Table 3. 10-year vs 30-year Treasury Bond Risk

	S&P500	*30-year Treasury*	*10-year Treasury*
Risk (std. dev.)	4.35	3.74	2.38
Risk Ratio	1	0.86	0.55

2.2. Credit Derivatives

Credit derivatives can be exposed to either both default risk and interest rate risk or to predominantly default risk. We first evaluate commenters' suggested adjustments for credit derivatives based on regulatory schedules by analyzing how the risk of corporate debt compares to the risk of equity. Then, we investigate credit derivatives that predominantly are exposed to default risk by comparing the risk of credit default swaps ("CDS") relative to the risk of equity.

[11] For the consistency of the analyses, we used U.S. Treasury series from Barclays obtained from Datastream. This data source is only available in a 1 to 5 year series, and a 2 to 5 year series cannot be separately derived from it.

[12] *See, e.g.* Comment Letter of Guggenheim Investments, *available at* https://www.sec.gov/comments/s7-24-15/s72415-163.pdf; Comment Letter of Pacific Investment Management Company LLC, *available at* https://www.sec.gov/comments/s7-24-15/s72415-168.pdf ("PIMCO Comment Letter"); Comment Letter of Capital Research and Management Company, *available at* https://www.sec.gov/comments/s7-24-15/s72415-153.pdf.

2.2.1. Corporate Debt

Table 4 reports risk levels using total returns of the S&P 500 and the indexes of the AAA- and BBB- rated bonds from 2004 to 2016, the period for which we have data available.

Table 4. Risk Analyses for Corporate Debt vs Equity

	(1)	*(2)*	*(3)*	*(4)*
Asset Class	*Risk Level (standard deviation of historical returns)*	*Initial Margin Requirement under PR/CFTC/BIS schedules*	*Risk Ratio implied by PR/CFTC/BIS schedules*	*Risk Ratio computed relative to Equity risk level*
Equity	4.09	15%	100%	100%
Credit: 0–2y duration	0.70[a]	2%	13%	17%
Credit: 2–5y duration	1.33[b]	5%	33%	33%
Credit 5+y duration	2.46[c]	10%	67%	60%

[a] Computed using AAA and BBB 1-3 years
[b] Computed using AAA and BBB 3-5 years and 5-7 years
[c] Computed using AAA and BBB 7-10, 10-15 and 15+ years

The implied risk ratios are, again, computed as the initial margin requirement for an asset class divided by the initial margin requirement for equity. Comparing columns 3 and 4, we observe that the implied risk adjustment ratios and the ratios we computed from the risk analyses are generally consistent for all three maturity categories.[13] For the short-term credit category, our analyses indicate that the PR, CFTC, and BIS schedules have an implied risk ratio that is slightly lower than the risk ratio computed, while for the long-term category, the risk ratio implied from the schedules is slightly higher. To evaluate a comment regarding adjusting risk on a continuum rather than by bucketing instruments together,[14] we note that dividing duration by 10 times 100% results in a continuum of risk ratios that is generally consistent with the risk adjustments in the regulatory schedules.[15]

[13] The maturities used in our risk analyses are slightly higher in order to provide for a comparable comparison between the values included in the regulatory schedules, which are determined on the basis of duration, and the values used in our analyses, which are based on the relevant securities' maturities.

[14] PIMCO Comment Letter (noting that a duration adjustment to a specified reference bond adjusts risk on a continuum rather than bucketing instruments with different risk characteristics together).

[15] For durations between 0.25 years and 2 years, between 2 years and 5 years, and between 5 years and 10 years, the adjusted risk ratios are between 2.5% and 20%, between 20% and 50%, and between 50% and 100%, respectively.

2.2.2. Credit Default Swaps

To evaluate the risk of CDS we compute standard deviations of CDS returns.[16] Table 5 reports the risk levels of returns of the CDX CDS index obtained from Capital IQ Inc. and those of total returns of the S&P 500 index. The data cover the period from 2008 to 2014, for which the CDS data is available.[17]

The table shows that returns for CDS contracts referencing high yield corporate debt are more volatile than those for CDS referencing investment grade corporate debt.[18] The CDS contracts that exhibit the highest risk level are those for high yield CDS with a tenor of 10 years.[19] The returns to these CDS have a standard deviation of 1.16 % per month and their risk ratio relative to equities is 24%.

Table 5. Risk Analyses for CDS vs Equity

		(1)	*(2)*
Asset Class		*Risk Level (standard deviation of historical returns)*	*Risk Ratio computed relative to Equity risk level*
Equity (S&P 500)		4.86	100%
CDS, investment grade	1y tenor	0.02	0%
	5y tenor	0.18	4%
	10y tenor	0.31	6%
CDS, high yield	1y tenor	0.29	6%
	5y tenor	0.84	17%
	10y tenor	1.16	24%

[16] Standard deviations are computed from daily data and scaled to monthly frequency using the square root of the average number of daily observations per month during the sample.

[17] CDS returns are computed as -Δ(CDS Spread)×PV01, where PV01 is the change in the value of the CDS contract, relative to the notional amount of the CDS, for a one percentage point increase in the CDS spread.

[18] In this table, we are not reproducing the initial margin requirements under the PR/CFTC/BIS schedules and the risk ratios implied by PR/CFTC/BIS schedules because the schedules do not distinguish between investment grade and high-yield corporate debt.

[19] In recommending how funds would use the PR/CFTC schedule, one commenter distinguished the way that funds should calculate the risk adjustment for credit default swaps from the calculation for other credit derivatives, suggesting that for credit default swaps, funds use the maturity or tenor of the swap, while for other derivative instruments, funds use the duration of the underlying reference asset. *See* ICI July 28, 2016 Comment Letter.

2.3. Currency

To understand the risk of currency, we estimate currency risk using the Nominal Broad Dollar Index, obtained from the Federal Reserve Board website.[20] The broad index is a weighted average of the foreign exchange values of the U.S. dollar against the currencies of a large group of major U.S. trading partners.[21]

We compare the risk of currency to the risk of the S&P 500 index from 1973 to July 2016, the period for which we have data for both data series. We follow the same approach discussed above by dividing the standard deviation of this currency basket by the standard deviation of the S&P 500. The comparison yields a risk adjustment multiplier of 29%, as compared to the 40% multiplier implied by the PR, CFTC, and BIS schedules. The schedules are broadly consistent with our analysis, which is based on a broad currency index that is highly diversified. This analysis, however, does not address whether narrower groupings of currencies or particular currencies would yield different risk adjustment multipliers.

3. Haircut Schedule

In addition to risk-based notional amount adjustments, commenters also suggested that the final rule permit funds to maintain high quality and liquid assets in addition to cash and cash equivalents as qualifying coverage assets.[22] Many commenters also suggested that the haircuts applicable to these assets be determined pursuant to the schedule of assets that may be used to satisfy the PR and CFTC margin requirements for uncleared swaps.[23] In light of these comments, we summarize assets that may be used to satisfy these margin requirements and analyze these assets and their corresponding haircuts in light of historical risk levels across certain asset classes.

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[20] The data is available from Federal Reserve Board website at http://www.federalreserve.gov/datadownload/Choose.aspx?rel=h10.

[21] For details on the construction of the index, see the article in the Winter 2005 Federal Reserve Bulletin, available at http://www.federalreserve.gov/pubs/bulletin/2005/winter05_index.pdf.

[22] *See* SIFMA Letter, *supra* note 2, at 29.

[23] *See id.*; *see also* ICI July 28, 2016 Comment Letter; Comment Letter of the US Chamber of Commerce (Mar. 28, 2016), *available at* https://www.sec.gov/comments/s7-24-15/s72415-148.pdf; Comment Letter of Vanguard (Mar. 28, 2016), *available at* https://www.sec.gov/comments/s7-24-15/s72415-162.pdf.

Table 6. Margin Values for Eligible Noncash Margin Collateral from PR/CFTC Schedules

Asset Class	*Discount %*
Eligible government and related (e.g., central bank, multilateral development bank, GSE securities identified in §23.156(a)(1)(iv)) debt[1]: residual maturity less than one-year.	0.5
Eligible government and related (e.g., central bank, multilateral development bank, GSE securities identified in §23.156(a)(1)(iv)) debt[1]: residual maturity between one and five-years	2.0
Eligible government and related (e.g., central bank, multilateral development bank, GSE securities identified in §23.156(a)(1)(iv)) debt[1]: residual maturity greater than five-years	4.0
Other eligible publicly traded debt[2,3]: residual maturity less than one year	1.0
Other eligible publicly traded debt[2,3]: residual maturity between one and five years	4.0
Other eligible publicly traded debt[2,3]: residual maturity greater than five years	8.0
Equities included in S&P 500 or related index	15.0
Equities included in S&P 1500 Composite or related index but not S&P 500 or related index[24]	25.0

[1] This category includes any security that is issued by, or fully guaranteed as to the payment of principal and interest by, the European Central Bank or a sovereign entity that is assigned no higher than a 20 percent risk weight under the capital rules applicable to the covered swap entity, or an OECD Country Risk Classification rating of 0-2.

[2] This category includes corporate and municipal debt securities that are investment grade, as defined by the prudential regulators.

[3] Note that GSE debt securities not identified in §23.156(a)(1)(iv) receive the same discounts as Other eligible publicly traded debt.

First, to understand how the schedule of assets that may be used to satisfy the PR and CFTC margin requirements for uncleared swaps relates to the underlying risk of certain margin-eligible assets, Table 7 reports haircut discounts computed based on historical risk levels of various asset classes and compares them to the schedules. The risk ratios reported in the table are calculated by dividing the standard deviation of the given reference asset by the standard deviation calculated for the S&P 500. The haircut discounts are then computed by multiplying that risk ratio by the haircut (15%) set for the S&P 500.[25]

[24] We did not analyze the risk associated with the S&P 1500 due to data limitations.

[25] Our review of Table 6 does not seek to analyze the entire PR/CFTC schedule, but rather to examine common categories of assets (U.S. Treasury securities, corporate debt, and equity).

Table 7. Haircut Schedule Based on Risk

		(1)	(2)	(3)	(4)	(5)
Asset Class		*Risk Level (standard deviation of historical returns)*	*Haircut/ Discount under PR/CFTC schedules*	*Risk Ratio implied by PR/CFTC schedules*	*Risk Ratio computed relative to Equity risk level*	*Haircut/ Discount Computed*[e]
Treasury[a,b]	<1yr	0.18	0.5	3%	4%	0.6
	1-5yr	0.62	2	13%	14%	2.1
	>5yr	2.48	4	27%	56%	8.4
Corporate[c,d]	<1yr	—[g]	1	7%	—[g]	—[g]
	1-5yr	0.90	4	27%	22%	3.3
	>5yr	2.24	8	53%	55%	8.3
Equity (S&P 500)		4.45[f] (4.09)	15	100%		

[a] The securities in the regulatory schedule are defined as eligible "government and related"
[b] The risk is computed using U.S. Treasury series from 1997 to 2016
[c] The securities in the regulatory schedule are defined to include certain eligible "publicly traded debt"
[d] The risk is computed using AAA and BBB corporate bond series from 2004 to 2016. The risk of corporate 1-5 year series is computed using 1-3 and 3-5 year corporate series
[e] Haircut Discount Computed = Risk Ratio Computed × Equity Haircut = Risk Ratio Computed × 15
[f] The risk levels of equity (S&P 500) are 4.45% from 1997 to 2016 and 4.09% from 2004 to 2016
[g] Due to data limitations, we do not analyze risk of corporate debt with maturity of less than 1 year

Comparing the existing discounts, or haircuts, reported in column 2 and the discounts based on risk levels reported in the last column, we observe that the existing haircut schedule generally is consistent with the underlying risk levels of the reference assets. The risk level of the long-term U.S. Treasury securities, however, based on historical risk levels, is higher than the risk level implied in the existing haircut schedule (i.e., 56% vs 27% as compared to equity). We note, however, that if we focus on the 5–10 year U.S. Treasury series, our risk analyses indicate a 35% risk ratio and a 5.3 haircut/discount, which are roughly consistent with the existing schedule.[26]

[26] Note also that corporate debt securities included in this analysis only consist of AAA and BBB bonds; high-yield categories are not included so as to facilitate the comparison with the existing schedule. Therefore, the risk differences between corporate and Treasury securities appear small, especially for the long-term maturity series. But our analyses show that high-yield bonds are more than twice as risky as comparable Treasury securities.

In addition, the 15% discount for domestic large capitalization equities is used in our analyses as a benchmark to compare risk levels and set the schedule. To understand whether this discount level is consistent with the observed volatility of large capitalization domestic equities, we further perform VaR tests on the S&P 500. These allow us to understand how much equity value can be expected to be lost under extreme conditions. Using monthly data from the past four decades, we observe that 1% of the time, the S&P 500 index can be expected to lose more than 11% in value over a month (*i.e.*, approximately 20 trading days). The haircut schedule included in the PR and CFTC rules for uncleared swaps is generally consistent with this analysis, in that it provides for a 15% haircut for large cap equity securities and provides a greater haircut of 25% for other equity securities that generally would be expected to experience greater volatility.

4. Risk Analyses for Crisis Periods

To further understand whether the values in the regulatory schedules are consistent during crisis periods when market volatility increases, we perform the above risk analyses using data from 2008 to 2010. Overall, the risk ratios among various asset classes stay roughly consistent with those found in the overall sample. The detailed results are attached in the appendix.

Appendix: Risk Analyses during 2008-2010

A.1. Risk Analyses for U.S. Treasury Securities vs Equity

	(1)	*(2)*	*(3)*	*(4)*
Asset Class	*Risk Level (standard deviation of historical returns)*	*Initial Margin Requirement under PR/ CFTC/BIS schedules*	*Risk Ratio implied by PR/CFTC/BIS schedules*[a]	*Risk Ratio computed relative to Equity risk level*
Equity	6.40	15%	100%	100%
Treasury IR: 0–2y	0.25[b]	1%	7%	4%
Treasury IR: 2–5y	0.80[c]	2%	13%	12%
Treasury IR: 5+y	3.62[d]	4%	27%	57%

[a] This is computed as initial margin requirement divided by the initial margin requirement of equity (15%).
[b] Computed using interest rate of Treasury 0-3 months, 1-2 years
[c] Computed using interest rate of Treasury 1-5 years
[d] Computed using interest rate of Treasury 5-10, 10-20, and 20+ years

A.2. Risk Analyses for Corporate Debt vs Equity

	(1)	*(2)*	*(3)*	*(4)*
Asset Class	*Risk Level (standard deviation of historical returns)*	*Initial Margin Requirement under PR/CFTC/BIS schedules*	*Risk Ratio implied by PR/CFTC/BIS schedules*	*Risk Ratio computed relative to Equity risk level*
Equity	6.40	15%	100%	100%
Credit: 0–2y duration	1.27[a]	2%	13%	20%
Credit: 2–5y duration	2.25[b]	5%	33%	35%
Credit 5+y duration	3.91[c]	10%	67%	61%

[a] Computed using AAA and BBB 1-3 years
[b] Computed using AAA and BBB 3-5 years and 5-7 years
[c] Computed using AAA and BBB 7-10, 10-15 and 15+ years

A.3. Haircut Schedule Based on Risk

		(1)	(2)	(3)	(4)	(5)
Asset Class		*Risk Level (standard deviation of historical returns)*	*Haircut/ Discount under PR/CFTC schedules*	*Risk Ratio implied by PR/CFTC schedules*	*Risk Ratio computed relative to Equity risk level*	*Haircut/ Discount Computed*[b]
Treasury[a,b]	<1yr	0.08	0.5	3%	1%	0.2
	1-5yr	0.80	2	13%	12%	1.9
	>5yr	3.62	4	27%	57%	8.5
Corporate[a]	<1yr	—	1	7%	—	—
	1-5yr[c]	1.56	4	27%	24%	3.7
	>5yr	3.59	8	53%	56%	8.4
Equity (S&P 500)		6.40	15	100%		

[a] Computed using AAA and BBB series
[b] Haircut Discount Computed = Risk Ratio Computed × Equity Haircut = Risk Ratio Computed × 15
[c] Computed using 1-3 and 3-5 year corporate series

THE INVESTMENT FUNDS INSTITUTE OF CANADA | L'INSTITUT DES FONDS D'INVESTISSEMENT DU CANADA

IFIC.CA

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
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

In care of

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Me Anne-Marie Beaudoin
Corporate Secretary
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800, square Victoria, 22e étage
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Montréal, Québec H4Z 1G3

Dear Sirs/Mesdames:

RE: CSA Notice and Request for Comment - Modernization of Investment Fund Product Regulation – Alternative Funds ("CSA Notice")

We are providing comments on behalf of the Members of The Investment Funds Institute of Canada in response to the CSA Notice and the proposed Framework for Modernization of Investment Fund Product Regulation – Alternative Funds (collectively, the "Proposal").

General Comments

Our Members appreciate the additional flexibility that the Proposal will provide "conventional" mutual funds for investments in commodities and investments in certain underlying funds. Allowing alternative funds to be made available to retail investors provides increased investment choice and access to new investment opportunities for retail investors.

We suggest several additional changes to the investment restrictions for "conventional" mutual funds to provide greater flexibility to investors.

It makes sense to bring alternative funds within the general framework of NI 81-102 because most of the same regulatory regime for mutual funds in NI 81-102 will also apply to alternative funds. To clarify the different investment restrictions that will apply to each type of NI 81-102 fund we recommend that a summary of the different investment restrictions are included in the Companion Policy 81-102 CP. We attach as Appendix B a comparison of the differences prepared by Borden Ladner Gervais LLP for your consideration.

In this letter we provide general comments on the Proposal, and comments on issues not specifically addressed in the CSA's questions. In Appendix A we provide responses to most of the questions posed in Annex A to the CSA Notice, however we have not responded to those questions relating solely to non-redeemable funds.

We also understand that several of our Members will make their own submissions raising unique issues and requesting consideration of other changes to the investment restrictions discussed in the Proposal.

"Alternative Funds" Label

In the Summary of Comments portion of the CSA Notice, the CSA note that the term "alternative fund" will only apply to mutual funds, for descriptive purposes, to reflect that these funds are permitted to engage in certain strategies or to invest in asset classes that are not necessarily available to more "conventional" mutual funds. The CSA further confirm that they are not proposing any mandatory naming conventions or other labelling requirements and are proposing removal of the warning label currently applicable to commodity pools because they recognize that not all alternative funds or strategies are inherently riskier than a "conventional" mutual fund.

Consistent with the CSA's intent, it is important that the descriptive terms "alternative fund" and "conventional mutual fund" not become defined terms. We see these descriptive terms as being a convenient substitute for more accurate but overlong and cumbersome descriptions such as "mutual funds that are permitted to adopt strategies not necessarily available to more conventional mutual funds".

We recognize the challenge in identifying one- or two-word product-type labels that conveniently distinguish between fund types, but the risk of adopting these descriptive terms as defined terms based on a notion of comparability between such funds presupposes understanding about the types of funds being compared, and whether they may be "alternative", "more conventional" or even "traditional". Disclosure that reflects each product's specific characteristics is preferable to labels that rely on comparisons, and mandatory comparative disclosure with other products such as that the CSA have in mind in the Proposal.

We echo this concern in our comments regarding the proposed Point of Sale disclosure requirements for alternative funds.

Investment Restrictions for Alternative Funds:

Definition of "Illiquid Asset"

The definition of "illiquid asset" in NI 81-102 is problematic. A key element of the definition is that the portfolio asset "cannot be readily disposed of through market facilities on which public quotations in common use are widely available at an amount that at least approximates the amount at which the portfolio asset is valued in calculating the net asset value per security of the investment fund,…" [emphasis added] . Accordingly any asset that can be readily disposed of at such a value, but only through a market where there is no widely available public quotation - perhaps the security trades only in an institutional market to which portfolio managers have access - would automatically be deemed to be an illiquid asset. Defining an asset is illiquid because it trades on a market that lacks public, or widely available, quotations is too narrow. In the institutional context, securities that can be readily traded for their appropriate value on a

market that provides full pre-trade price transparency to all participants in that market, and that otherwise do not have the risks associated with truly "illiquid" securities, should meet the test for liquid assets.

We acknowledge that liquidity risk management goes beyond the Proposal, and that currently there are a number of initiatives internationally on liquidity risk management for investment fund products that the CSA are monitoring for potential impact on their work. We welcome further discussions with the CSA on this topic.

We understand that several of our Members will make submissions that raise unique issues and propose options with respect to the current definition of illiquid assets as it applies to their respective businesses.

Investments in Illiquid Assets

The Proposal imposes the same limit on investments in illiquid assets as applies currently to "conventional" mutual funds (10% of NAV at the time of purchase, with a hard cap of 15% of NAV). This contrasts with the 20% of NAV limit proposed for non-redeemable funds. We recommend the CSA consider adopting, for alternative fund investments in illiquid assets, a higher time of purchase limit, at least consistent with the 15% limit for mutual funds in the United States. In 1992 the U.S. Securities and Exchange Commission increased the permitted level of mutual fund investments in illiquid assets from 10% to 15% of NAV[1]. The rationale for allowing mutual funds to invest an additional 5% of their net assets in illiquid securities was to provide additional capital to small business without significantly increasing the risk to any fund. Assessing the experience of U.S. mutual funds since this limit was increased should provide evidence that a similar increase for alternative funds in Canada is unlikely to significantly increase the risk to these funds.

Borrowing

Proposed section 2.6(2) of NI 81-102 states that "An alternative fund or a non-redeemable investment fund may borrow cash in excess of the limits set out in subsection (1) provided that … (c) the borrowing agreement entered into is in accordance with normal industry practice and on standard commercial terms for the type of transaction." [emphasis added]. For greater clarity, we request confirmation that alternative and non-redeemable funds will be permitted to grant a security interest in their assets and/or give indemnities in respect of borrowing arrangements under 2.6(2), both of which are considered normal industry practices.

We also request a clarifying amendment to proposed section 2.6(2), specifically the portion that states "borrow cash in excess of the limits set out in subsection (1)…" The amendment should make more explicit how the existing 5% borrowing limit to settle portfolio transactions in subsection (1) will interact with the new 50% borrowing limit for borrowing for leverage.

Fund-of-Fund Structures

Although the Proposal permits "conventional" mutual funds to invest up to 10% of NAV in alternative funds and non-redeemable investment funds subject to NI 81-102, we recommend the CSA consider increasing this limit to 20% of NAV to provide investors access to more flexible alternative investment strategies.

We commend the CSA for codifying commonly-granted relief regarding investments in other mutual funds. We recommend that the CSA also consider codifying existing exemptive relief granted to a number of mutual funds permitting them to invest in ETFs traded on exchanges in jurisdictions outside of Canada (for example, U.S.-listed commodity-tracking ETFs). Consistent with the conditions that accompany those relief orders, the regulatory regime applicable to

[1] Revisions of Guidelines to Form N-1A, Federal Register, Vol. 57, 9828, 9829 (March 20, 1992).

those ETFs should be equivalent to those applicable to similar Canadian ETFs and the stock exchanges in those jurisdictions should be subject to equivalent regulatory oversight to securities exchanges in Canada.

Again in relation to commodity investments we request clarification on how the "look through" test for physical commodity investment limits relates to the underlying fund investment limit. It should be made clear whether a commodity ETF is included in the calculation set out in s. 2.3(3) and, if so, whether it is to be excluded from the underlying fund restrictions in s. 2.5.

Point-of-Sale Disclosure

In addition to our response to the CSA's specific questions on Fund Facts disclosure, we have comments on several aspects of the proposed disclosure requirements for alternative funds. We encourage the CSA to consult specifically on the content of the alternative fund point-of-sale disclosure documents, in particular the Fund Facts, once the substantive disclosure issues have been settled.

As we noted earlier, we concur with the CSA's decision not to mandate naming conventions or other labelling requirements for the various investment fund types, and to maintain phrases such as "alternative fund" and "conventional mutual fund" as descriptive terms and not as defined terms. This means that care must be taken to avoid the introduction of such descriptive terms into the point-of-sale documents as if they were defined terms. For example the proposal to require a text box in the Fund Facts that reads, in part: "This mutual fund is an alternative fund" uses the descriptive term as a defined term contrary to the CSA's intent to avoid labelling.

Our Members disagree with the proposal to require comparative disclosure in the point-of-sale documents. It is essential that the point-of-sale documents provide disclosure of the characteristics of the particular investment funds that are described in them. However mandating language in the disclosure documents that, for example, compares alternative funds with "conventional mutual funds" might be entirely misleading to investors. It is understood that an investor should know the differences between two funds that may be recommended to them, regardless of the type(s) of funds in those recommendations. In this regard we support consultations with IIROC and the MFDA to determine how differences between various types of investment fund are, or ought to be, discussed with clients. This would inform the development of the appropriate disclosures that will best support those client discussions.

Fund Risk Methodology

We appreciate the CSA's confirmation (in Annex B to the CSA Notice) that there is no presumption that all alternative funds are more risky than "conventional" mutual funds and that the CSA's mandatory risk rating methodology based on standard deviation would also be applicable to alternative funds.

As the CSA just released its final risk rating methodology on December 8, 2016 we are only now able to analyze the applicability of that methodology to alternative funds, and whether the proposed broader access to certain asset classes and investment strategies might necessitate modifications to the methodology.

There is more work to be done before the methodology can be applied to alternative funds. For instance, the Canadian Investment Funds Standards Committee ("CIFSC") currently has only one general "catch-all" category for funds that apply "alternative strategies". This is due primarily to the wide variety of different investment strategies used by those funds, making it difficult to compare one fund with its peers. IFIC's Fund Categorization Working Group is considering the best categorization approach to recommend to CIFSC for these funds. It is hoped that fund managers will not apply their own individual criteria to the alternative funds they manage. Similarly, as the CSA have already acknowledged, applying a blanket classification of "high risk" to all of these funds, without further analysis, is inappropriate and not necessarily accurate in all cases.

Distribution of Alternative Funds:

The Proposal replaces the current commodity pool proficiency requirements in NI 81-104 with the current proficiency and suitability requirements for investment fund distributors. The MFDA, in conjunction with the CSA, may require additional proficiency. We look forward to working with the MFDA as it considers the appropriate requirements for distribution of alternative funds by MFDA members and registrants, and to assisting MFDA registrants to become proficient to distribute these products in time for implementation of the framework.

Alternative Fund Financial Disclosure

IFIC's Accounting Advisory Working Group notes that the CSA Notice does not seek comment on the potential implications of the Proposal on existing MRFP disclosure requirements in NI 81-106. Some clarification in this regard may be helpful, in particular relating to TER and total return calculations. Commentary on treatment of costs related to short sale transactions would be beneficial to ensure consistency of application. In addition, the benefit and understandability of the split of total return between short and long portfolio positions should be considered. We would be happy to provide additional details on these matters.

* * * * *

We appreciate the opportunity to comment on the consultation. If you have any questions or comments, please contact me by email at rhensel@ific.ca or by phone at 416-309-2314.

Yours sincerely,

THE INVESTMENT FUNDS INSTITUTE OF CANADA

By: Ralf Hensel
General Counsel, Corporate Secretary & Vice President, Policy

CSA Alternative Funds Framework

Responses to Questions in Annex A to CSA Notice

Topic:	CSA Question:	Industry Response:
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 Members are content with the phrase "alternative funds" for these products on the basis that this phrase will be used as a descriptive term, and not become a defined term for use in a mandatory naming convention or labelling requirement.
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.*	Our Members have identified loans, loan syndications (without regard to administrative responsibilities), real estate and mortgages as common asset classes under typical "alternative" investment strategies that should also be contemplated for investment by alternative funds.
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.*	Our Members are generally content with the proposed concentration limit for alternative funds of 20% of NAV at the time of purchase, and do not believe a hard cap is necessary.

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.*	Alternative funds commonly use several strategies for which a higher illiquid asset investment threshold is appropriate, including investments in distressed securities, loans and non-guaranteed mortgages, as well as merger arbitrage strategies. Investing in such assets is intended to capture an illiquidity premium associated with such assets.
	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, the frequency of redemptions of an alternative fund should be considered in determining the appropriate illiquid asset limit, as the less frequent the fund's redemptions, the more illiquid the assets can be, and vice-versa. A fund's redemption frequency is a key consideration in the responsible management of its investment portfolio.
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*	Yes, alternative funds should be permitted to borrow from a broader range of entities beyond those that qualify as a custodian for investment fund assets in Canada, which the CSA have confirmed, includes dealers that act as prime brokers in Canada. The Proposal does not identify the CSA's concerns underlying the restriction to Canadian. At the very least, alternative funds should be permitted to borrow from U.S. lenders since funds are already permitted to post U.S. collateral against their borrowing. The CSA have confirmed that Canadian prime brokers are permitted lenders, but some funds use non-Canadian prime brokers that often provide them with credit. In light of established business practice, and absent more information about the CSA's concerns, we recommend that alternative funds also be permitted to borrow from non-Canadian 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, absolute return funds may find the proposed leverage limit to be insufficient, as would funds that are hedging different sources of risk, particularly if they use multiple hedging instruments, unless borrowing for hedging purposes is excluded from the calculations as is recommended in our response to question 10.
	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?*	The proposed 3X leverage limit should exclude the use of specified derivatives for hedging purposes, since such borrowing does not impact the amount leveraged. Similarly short-sales of government securities should be excluded from the short-selling limit calculations.
	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.*	Our Members are generally satisfied with the use of the notional amount calculation method.

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.*	It would be helpful if the CSA could provide a sample Fund Facts for alternative funds. Consistent with our view that disclosure comparing alternative funds and "conventional" mutual funds is unnecessary, we recommend such disclosure be removed from the Fund Facts. The CSA have noted the central objective of the Fund Facts is to provide key information that is important for investors to consider when they purchase an investment product. There is currently no comparative language in the Fund Facts for "conventional mutual funds" as against any other fund types. In the summary disclosure regime for ETFs released on December 8, 2016, the CSA have mandated disclosure in the ETF Facts about the unique trading and pricing characteristics of ETFs, but no mandated comparative language as against mutual funds, with the exception of a minor reference to similarity, "like mutual funds", required in the Trading ETFs and Net asset value (NAV) sections. We urge the CSA to be consistent in their disclosure requirements in the ETF Facts and Fund Facts for all mutual fund types. The proposed requirement to include in the point of sale disclosure documents of an alternative fund the phrase "This mutual fund is an alternative fund", as is proposed to be included in the text box on the Fund Facts, or a similar phrase, is inappropriate and inconsistent with the CSA's confirmation that they are not proposing any mandatory naming conventions or other labelling requirements for alternative funds. The phrase "alternative fund" is meant to be for descriptive purposes only and is not to become a defined term.

		Our Members have other concerns with the proposed mandated content, and location of certain disclosures, in the proposed Fund Facts for alternative funds. It is more helpful to readers to have disclosure of unique characteristics of alternative funds in the appropriate section(s) of the document. As an example, information on redemptions is best included in the Quick Facts section. We suggest discussions with IIROC and the MFDA to determine how differences between the various investment funds ought to be discussed with clients. This would help inform the most appropriate disclosure to include in the Fund Facts to support those client discussions.
	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?*	We appreciate the CSA's confirmation that there is no presumption that all alternative funds are more risky than "conventional" mutual funds and that the CSA's mandatory risk rating methodology based on standard deviation could also be appropriate for alternative funds. More analysis of the CSA's final risk rating methodology for mutual funds and ETFs, released on December 8, 2016, will be necessary to consider the applicability of that methodology to alternative funds and to identify any modifications to the CSA methodology that may be necessary.

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*	There are no obvious unique challenges from the fund managers' perspective with respect to implementing point of sale disclosure for non-exchange traded alternative funds. Investment fund managers are already well-versed in the production and filing requirements for the simplified prospectus, AIF and Fund Facts documents. There should be few, if any, documentary challenges on the distribution side. However, necessary advisor and dealer training on these new products, particularly to prepare for discussions with clients about the features of alternative funds, and implementation of potential new proficiency requirements in the MFDA channel will result in transition costs for distributors.
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.*	We expect that it will be primarily existing closed end funds and commodity pools created under NI 81-104 that would seek to transition into the new alternative funds regime in NI 81-102. To ease any transition that may be required or desired we recommend that one-time blanket exemptive relief be included in the final rule, and that the relief make it clear that there is no requirement forcing existing funds to transition over to the new regime.

REVISED NI 81-102 INVESTMENT RESTRICTIONS – *AT A GLANCE*

Investment Restriction*	Alternative funds	Conventional mutual funds and ETFs (mutual funds)	Closed end funds (Non-redeemable investment funds)
Proposed changes are indicated in bold italic type			
Concentration Restriction	***20 percent of NAV, subject to carve-outs***	10 percent of NAV, subject to carve-outs	***20 percent of NAV, subject to carve-outs***
Control restriction	No more than 10 percent of votes / equity securities of an issuer		
Restrictions on types of investments	No investment in: • real property • mortgages other than guaranteed mortgages • loan syndications / participations if any responsibility for administering the loan	No investment in: • real property • mortgages other than guaranteed mortgages • ***commodities other than 10 percent in certain precious metals (waived for precious metals funds)*** • loan syndications / participations if any responsibility for administering the loan	***No investment in:*** • ***real property*** • ***mortgages other than guaranteed mortgages*** • ***loan syndications / participations if any responsibility for administering the loan***
Illiquid assets	10 percent of NAV at time of investment (hard cap of 15 percent)		***20 percent of NAV at time of investment (hard cap of 25 percent)***
Fund-of-fund investments	• ***100 percent in underlying alternative mutual funds, non-redeemable investment funds, conventional mutual funds and ETFs***	• ***10 percent in underlying alternative funds and non-redeemable investment funds*** • ***100 percent in underlying conventional mutual funds and ETFs***	• ***100 percent in underlying alternative funds*** • 100 percent in underlying non-redeemable investment funds, conventional mutual funds and ETFs
Borrowing	***Limited to 50 percent of NAV, subject to restrictions***	Limited to 5 percent of NAV, subject to restrictions	***Limited to 50 percent of NAV, subject to restrictions***
Short-selling	***Up to 50 percent of NAV, with single issuer limited to 10 percent of NAV; no cash cover required***	Up to 20 percent of NAV, with single issuer limited to 5 percent of NAV; 150 percent cash cover required in all cases	***Up to 50 percent of NAV, with single issuer limited to 10 percent of NAV; no cash cover required***
Total borrowing and short-selling	***Aggregate limit of 50 percent of NAV at all times***	N/A	***Aggregate limit of 50 percent of NAV at all times***
Derivatives for hedging and non-hedging purposes	• ***No designated rating requirements for the derivative or counterparty*** • ***Counterparty exposure limit of 10 percent of NAV for derivatives, other than for cleared specified derivatives***	• Designated rating requirements for the derivative or counterparty • Counterparty exposure limit of 10 percent of NAV	• ***No designated rating requirements for the derivative or counterparty*** • ***Counterparty exposure limit of 10 percent of NAV for derivatives, other than for cleared specified derivatives***
Derivatives for non-hedging purposes	Exempt	Cover required for specified derivatives transactions	Exempt
Leverage	***Cannot exceed 3x NAV***	Leverage prohibited	***Cannot exceed 3x NAV***
Securities lending, repurchase and reverse repurchase arrangements	Permitted, subject to conditions		

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December 22, 2016

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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Me Anne-Marie Beaudoin
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Autorité des marchés financiers
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Fax: 514-864-6381
Email: consultation-en-cours@lautorite.qc.ca

Dear Sirs / Mesdames:

Re: Modernization of Investment Fund Product Regulation – Alternative Funds

First Asset Investment Management Inc. appreciates the opportunity to comment on the proposed repeal of National Instrument 81-104 *Commodity Pools,* the proposed amendments to National Instrument 81-102 *Investment Funds* and National Instrument 81-101 *Mutual Fund Prospectus Disclosure* and the proposed consequential amendments that were published on September 22, 2016 (the "**Proposed Amendments**").

Upon review of the Proposed Amendments, we urge the Canadian Securities Administrators (the "**CSA**") to consider grandfathering existing investment funds from the Proposed Amendments that impose new investment restrictions. Imposing new investment restrictions on existing investment funds will alter, in some cases radically, the commercial bargain entered into by securityholders and the funds at the time of investment, which may have an adverse effect on the performance (and viability) of funds that have otherwise successfully implemented their current investment strategies for the benefit of their securityholders. Further, such changes will impose significant costs on such funds (and indirectly their investors), who must now change their investment strategies to comply with the new regulations. We respectfully submit that

these costs far outweigh any potential benefits that may accrue to investors in existing funds from the Proposed Amendments.

While, in the CSA Notice and Request for Comment accompanying the Proposed Amendments, the CSA have concentrated on the issue of fairness, we do not believe adequate attention has been paid to fairness to existing funds who will be significantly negatively impacted by the Proposed Amendments. We believe grandfathering these funds with respect to the Proposed Amendments is the only way to avoid prejudicing such issuers.

* * * * *

Thank you for providing us with this opportunity to comment on the Proposed Amendments. We would be pleased to provide further details regarding our comments upon request from the CSA.

Yours truly,

First Asset Investment Management Inc.

Per: _____

Z. Edward Akkawi
Chief Operating Officer & General Counsel

INCLUDES COMMENT LETTERS

CSA PROPOSAL

AVIVA INVESTORS COMMENTS

DECEMBER 2016

AVIVA INVESTORS

AVIVA INVESTORS COMMENTS

TO CSA PROPOSAL

AVIVA INVESTORS

Date: December 22, 2016

Firm Name: Aviva Investors Canada Inc.
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Firm Telephone: 416-360-2767
Firm Facsimile: 416-361-2815
Firm Website ca.avivainvestors.com

Executing Officer: Tyler McGraw
Title: Managing Director, President

Signature:

To CSA members:

British Columbia Securities Commission
Alberta Securities Commission
Financial and Consumer Affairs Authority of Saskatchewan
Manitoba Securities Commission
Ontario Securities Commission
Autorite 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

Dear:

The Secretary
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E mail: comments@osc.gov.on.ca

Me Anne-Marie Beaudoin
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INTRODUCTION

Aviva Investors appreciates this opportunity to comment on the proposed rule amendments. Our strategy is to be a Global Leader in outcome oriented solutions, and we strongly believe that embedding risk management at the heart of the investment process is the most effective way to deliver clients the outcomes that they are seeking. As a large global asset management firm with experience operating funds across many different regulatory regimes, we offer our insights and thoughts on the proposed rule. Aviva Investors shares the CSA's view on the importance of higher standards of risk management and increased Fund supervision. Many of the proposals, have operated successfully in a number of markets and we clearly support these.

In the proposal, the CSA sought answers from industry participants. Aviva Investors ("AI") has provided its responses to those questions based on our experience and knowledge. AI believes that investors typically have one of a small number of outcomes that they want to achieve with their investments: achieving capital growth, beating inflation, meeting a defined liability and generating income. These outcomes may appear simple on the surface; nonetheless we recognize that markets do not always rise, and simplistic long only funds may not deliver on these outcomes. AI is clear that it believes investors are best served by having access to a range of well-controlled investment strategies. As a result, restrictions such as those proposed need to balance the goals of investor protection against the merits of derivative usage in the investment strategy for the purpose of risk management and efficient portfolio management. AI believes that this can be achieved through a combination of principle based regulation and more prescriptive measures. We set out our detailed thoughts in the letter below.

Question 1;

We believe that replacing the term 'commodity pool' with 'alternative fund' is appropriate as this is a more investor friendly name and should avoid confusion for those who may believe the funds only can invest in forms of physical commodities.

Question 2;
We believe that all liquid investment classes are encapsulated by the proposals and we don't believe there is an additional investor benefit from expansion of those beyond the current scope.

Question 3;
We agree with the CSA in principle that an avoidance of concentration to a single issuer, such as a bank/corporate entity, is necessary to enhance protection of investors. However, we would encourage the rules being in alignment with those of the UCITS standards of the European Union, that is to say, we believe it is possible that an investor should be able to get greater exposure to gov't/supranational securities and the like. Furthermore we would encourage the CSA to consider the concentration to include exposure to MTM of OTC derivatives. For example, an alternative fund could gain no more than 20% exposure to a financial institution through equities, bonds, cash instruments such as CD & CP and OTC MTM liabilities which are uncollaterised. We would also suggest that this should be measured not just at point of entry but also on an ongoing basis (likely to be each day when the pooled vehicle has a struck NaV).Should a vehicle exceed this restriction on a passive basis, it is expected to have a plan to reduce the exposure to below the restriction when it is in the investor's best interest, and as soon as reasonable possible given the requirement to act in the investor's best interest. Although monitoring passive breaches is currently beyond regulatory requirements and market practices, we suggest CSA considering mandating this as an additional risk management safeguard.

Question 4;
We have no comments on question 4.

Question 5;
We agree with the question that matching subscription/redemption windows to the liquidity of the underlying investments is a prudent approach in order to safeguard investors. Therefore, a fund should only contain investments which match the ability of the shareholders to retrieve their investments in an orderly manner. For alternative funds with daily liquidity we would suggest that assets should meet the generally accepted definition of liquid such as being a transferable security or a fund.

Question 6;
We have no comments on question 6.

Question 7;
We have no comments on question 7.

Question 8;
We would suggest that borrowing powers are limited depending on the investment goal/asset class, as we do not believe that investors are well served in liquid markets through persistent structural and non-negligible borrowing for the purposes of reinvestment in said liquid markets. However, we do understand that in the case of illiquid markets, such as real estate/infrastructure, the ability to borrow on a long term structural basis for the purpose of providing investment return might indeed be suitable. Therefore, we would suggest that the right to borrow be limited to 10% on an incidental/short term basis for the purposes of day-to-day fund management (as opposed to generating leverage for investment return), with exceptions being granted on a case by case basis on application in the fund perspective approval phase once the rationale for said borrowing has been demonstrated.

We agree with the CSA that it is necessary to have a single combined exposure limit applicable to the aggregate of all transactions that generate exposure, regardless whether the exposure is generated through financial commitment transaction, derivative transactions or other senior securities transactions. It appears the proposal does not specify the borrowing limit as a result of other senior securities transactions under the new rule. Our preference is a more nuanced approach to the setting of leverage restrictions and the separation of borrowing to create leverage versus the use of derivatives. Should the CSA accept our proposed refinements discussed below, we believe this could also allow for a reduction of the restrictions on borrowing to a significantly lower level.

We agree that in a limited number of investment strategies the ability to borrow on a long term structural basis for the purpose of providing investment return might well be suitable; however, it is important that the risks are clearly explained in publically available information to the underlying investors. Broadly speaking, these uses can be divided into funds with the sole aim of investing in non-liquid markets, such as real estate, illiquid assets and infrastructure.

In regards to the broader question about the source of this borrowing, from a macro prudential perspective, we would urge the CSA to consider a range of additional diverse market participants as being suitable. We believe that broadening the definition of entities from which a fund can borrow could include:

- A credit institution authorized in Canada
- A credit institution authorized in the EEA
- A credit institution authorized within a signatory state to the Basle Capital Convergence Agreement of July 1998
- A credit institution authorized in Australia or New Zealand or other G7 country

We respectfully suggest that broadening the base of competition in the market would likely lower the costs to the funds and likewise dilute any potential systemic feedback loops by spreading the counterparty risk amongst willing and able market participants.

Question 9;

While we applaud the goal of the CSA to improve investor protection from inappropriate levels of risk, we believe the exposure limit as proposed does not provide sufficient flexibility to some low risk funds, such as outcome oriented funds which use derivatives to achieve return objectives and low volatility. These are commonly referred to as liquid alternative funds. We believe using derivatives to gain exposure does not inherently increase the risk of the fund, since derivatives and physical assets display similar return and risk characteristics. With proper risk controls, using derivatives to gain exposure has certain benefits as listed below, and therefore, should not be penalized compared to those funds using derivatives as a hedging tool in a traditional sense.

1. Derivatives may allow funds to gain exposures that physical assets cannot provide. As a result, these funds may provide better diversification than traditional balanced portfolios, especially during stressed market conditions when volatility for physical assets, such as stocks and bonds, tends to go up simultaneously.

2. Derivatives may offer better liquidity than physical assets. Regulatory changes in the banking industry since the financial crisis have reduced the number and scale of market makers. Better liquidity provided by derivatives allows fund managers to increase and decrease exposure more quickly, which is critical for risk management purposes.

3. There are certain asset classes, such as FX, where the bulk of the market is OTC and derivative.

   As a result, we suggest the CSA considers extending the same flexibility to funds already using the VaR approach similar to UCITS, conditional upon meeting additional controls, such as back testing.

   We appreciate the CSA's concerns regarding leverage; however, the proposed exposure limit at 300% appears to cause issues for other liquid alternatives and fixed income funds that use derivatives to achieve a wide array of client outcomes.

   Without providing sufficient flexibility to mutual funds to deploy derivatives, there may be unintended negative impacts to investors such as the following:

   1. Force a greater concentration of mutual fund assets into long-only strategies that are increasingly susceptible to market volatility and liquidity risk, and may be more susceptible to suffering negative total returns.

   2. Drive demand for offshore funds which will continue to access derivative strategies. Although many retail investors don't have direct access to offshore vehicles, a review of shareholder information for certain large alternative funds indicates that many large shareholders of these funds are institutional vehicles with retail assets, such as pension funds. The demand for stable return and low volatility may force those pension funds to increasingly rely on offshore vehicles, such as those in Cayman Islands and British Virgin Islands, which places Canadian mutual funds at a significant competitive disadvantage for institutional clients and denies retail clients access to many suitable or indeed superior products.

3. Product innovation may lead to more opaque products that are harder to regulate.

As discussed above, we believe that the current proposed restriction of 300% leverage may prevent investors from achieving their outcomes. Instead, we believe that the approach of utilizing a VaR based restriction. Moreover, we respectfully suggest that the investment manager should disclose in their fund's disclosure documentation the maximum expected leverage. While this may not constitute a limit, it would be expected that the manager should not exceed this disclosed level in the normal course of management, and higher levels of leverage should only occur for short periods of time.

In addition, it is our view that the proposed 300% leverage limit would make CSA regulations more stringent than other regimes, such as UCTIS rule and applicable rules for 40 Act funds in the US. Under UCITS framework, the exposure limit for sophisticated funds is a self-defined threshold that's usually higher than 300% with additional risk management safeguards, such as VaR limit. Under the current SEC rules, derivatives exposure for mutual funds is managed through asset coverage instead of a hard cap on exposure. Under the proposed SEC derivatives rule (18f-4), although the default nominal exposure limit is 150% (300% if derivatives usage reduces VaR), the calculation offers more flexibility than the current CSA proposal in certain areas. For example, purchased options are excluded from the exposure calculation under 18f-4. The reasoning provided by the SEC is that potential loss for purchased options is capped at the premium paid and investors cannot lose more than what they've invested in. Therefore, the SEC suggest that it is appropriate to treat purchased options differently than other derivatives, such as sold options, futures and swaps.

Question 10;
The proposed risk-based limit heavily restricts the use of derivatives to transactions which are classically referred to as 'hedges'. Hedges are trades, typically through derivatives, which specifically reduce market risk. However, the proposals as currently crafted restrict the use of derivatives to construct significantly more robust portfolios, and, therefore, may worsen the outcomes that clients receive.

Question 11;
We agree with the CSA that the notional amount of derivatives may not be an appropriate measure of risk. Indeed, in some cases, it may well be at best unhelpful and at worst it may mislead clients as to the true level of risk they are employing in their investments.

AI does not believe that a single methodology exists at present to accurately explain fund leverage, and therefore any purely prescriptive approach will unfairly penalize some investment strategies. This does not imply that the approach presented in the proposal is without merit, but instead recognizes that there are flaws in any approach and that these should be compensated for where possible. We support the CSA in seeking to highlight to clients where and when leverage is being used, and particularly where it can magnify the risks of an investment. However, we believe that the term leverage needs to be clearly defined. Generally speaking, leverage can be achieved through the use of borrowing cash to reinvest or via the use of derivatives. In the former case, we agree with the CSA that clients should be clearly informed, or possibly better protected, by a tight restriction on borrowing. In line with this, we would suggest the CSA introduces a fund level restriction of 10% for borrowing, which should be temporary in nature to facilitate short-term cash management and fund liquidity.

The second instance where leverage can be achieved is through the use the financial instruments generally referred to as derivatives. We believe that the generation of 'leverage' through this means should be clearly disclosed to investors by the fund manager and that

suitable controls should be in place to measure, monitor and control the use of this leverage. AI believes that the establishment of the RMP (Risk Management Process) is a vital component of this process and that this document should clearly state the mechanisms through which the controls operate. A vital component of this control should be a clearly stated and explained methodology for calculating leverage. We believe the majority of the proposal is in line with other globally observed practices and shares their collective strengths and weaknesses. We would encourage the CSA to consider that 'physical' assets should carry leverage within the calculation; hence the base leverage for all funds is 100%. We propose that this is a fairer representation of the risk and also avoids the pitfall of a derivative only replication position appearing more risky than the equivalent investment in assets. Indeed, there is much supporting evidence to suggest that in the case of synthetic replication, the investment might well have better risk and return characteristics.

In answer to the question raised by the CSA as to instruments where notional was less suitable to measuring the risks involved, and assuming that the CSA does not adopt our preferred solution of aligning to the UCITS requirements, we believe that the current proposal unfairly penalizes Fixed Income and FX risk relative to Equities. For example, on the basis of the current calculation, $1million of equity notional has the same leverage as $1million of Fixed Income or FX notional irrespective of the levels of volatility and, hence, risk. In many cases, the risk of Fixed Income investments can be substantially lower than the equivalent level of Equity investments. As a result, we feel that the 'sum of the notionals' approach may unfairly generate an expectation that the level of risk is the same to the end client. We would suggest that in the case where the CSA prefers to stick with the simplicity of the proposed calculation, they permit a significantly higher level of leverage and that they pass the responsibility to the fund manager to set an appropriate level of leverage in line with the Fund's investment objective under that threshold. In order to facilitate this, we believe that fund should publish the maximum level of expected leverage to the investors in the prospectus and, during the production of required investor information, include the level of leverage as of the appropriate date in said information. Furthermore, the fund manager should ensure that it is comfortable that the investment manager is capable and skilled in the use of the derivatives deployed in pursuit of the investment objective.

As a result of the aforementioned weaknesses in the assumption of the equivalence of risk between investments, we believe a suitable alternative should be employed by the Investment Manager. This should take into account the risks of the underlying investment from a market risk perspective. The fund may use this definition if the fund manager considers it suitable, and appropriate public disclosures on the methodology have been provided to the investors.

1. Interest Rate 'sensitive' products: We suggest that swaps/futures/interest rate sensitive products (An interest rate sensitive product should primarily have 'sensitivity' to changes in the price of the underlying rate curve.) could be expressed as a 'delta' equivalent of the risk-free 10-year bond. For example, a fund buying USD swaps can equate the risk of that position through IR01 (IR01 being defined as the interest rate sensitivity to a 1bp change in the underlying 'risk-free' curve, this may be referred to as IR Delta or Delta amongst other terms in the industry.) to the equivalent amount of the 'generic/on the run' 10-year US Treasury.

2. Foreign Exchange 'sensitive' products: We suggest that FX sensitive products could be expressed as a 'delta' (FX Delta being defined as the sensitivity to a 1% change in the underlying currency.) equivalent. This is for either leg of the currency pair and should be expressed as an amount of the base currency of the fund.

3. Credit Spread 'sensitive' products: In line with the suggestion with regards to Interest Rate sensitive products, we believe an acceptable approach would be to measure the equivalence on a CS01 (CS01 being defined as the credit spread sensitivity to a 1bp change in the underlying credit curve; this may be referred to as CS Delta) basis', which could be combined with the IR Delta.

Where a product contains more than one type of risk, all relevant risks should be included in the exposure calculation. Where CS01 & IR01 are applicable, the larger of the two must be included. While we acknowledge that this approach has some shortcomings, it may represent a more accurate picture of leverage to the underlying investor.

We would also like to point that other industry groups also proposed to apply risk-based adjustments when calculating notional as it is widely acknowledged that the same notional amount for different investment instruments may provide very different risk profile. AI participated in a working group organized by Investment Company Institute which proposed that the SEC adopt a risk-based adjustment schedule based on the inherent riskiness of each instrument type when calculating the exposure. Although the SEC has not formally adopted ICI's proposal, it has commissioned an economic study to seriously evaluate the proposal. AI's response to the SEC regarding 18f-4 proposal, ICI proposal on risk-adjustment, and the SEC's economic study are attached.

Regardless of the approach taken, be it a simple 'sum of the notionals' or the approach described above, AI believes that transparency is in the client's best interest, and hence a practical example of how each instrument in the portfolio is being handled should be publicly available for investors to review. While the approach described above improves the accuracy of the calculation for the investor in the fund, we agree that this does not make it possible for funds to be compared between providers with different approaches. Therefore, if the fund chooses to utilize its own definition of leverage, a 'sum of the notionals' leverage total should be disclosed along with the level of fund VaR. In the case of VaR, it is our thought that the investor disclosure documents should also contain a 'plain English' explanation of the term VaR.

As the 'sum of the notionals' approach is clearly understood, the requirement to calculate VaR would be in place and the fund would be able to define leverage accordingly. We do not believe this approach would likely place an onerous load on the compliance and risk staff of the fund manager. However, we recognize that this 'triple-lock' approach to the disclosure requirements means that funds and their managers will have to invest in suitably skilled, trained and experienced experts, thereby increasing the level of protection that clients can reasonably expect.

Furthermore, we advise the CSA to include all instruments held within a portfolio for the purpose of leverage calculations. We believe that physical and synthetic instruments introduce the same portfolio risks and therefore should be treated equally for the purposes of leverage calculations. Some may argue that purchased options should be excluded from leverage calculation, since unlike futures and swaps, investors in purchased options would not lose more than the invested amount. In fact, purchased options were excluded from leverage calculation in SEC's derivatives proposal 18f-4. We believe that both purchased options and sold options should be included in leverage calculations. While the exclusion of purchased options would seem outwardly appealing to many, we believe this is merely because it reduces the leverage calculation as opposed to it having merit from a risk management perspective.

We can demonstrate through an example. If an investor wishes to replicate the S&P 500 index they may buy every share in the index to generate the exposure in Fund A or they could choose to buy a call and sell a put which will give them the same 'exposure' (Exposure here is defined as the financial impact from a change in the value of the S&P) in Fund B. If purchased options were excluded, only one leg of the transaction is included towards leverage, the sold put within Fund B,

because physical asset purchases are excluded, as are purchased options, which misleads the investors in Fund B and misrepresents the risk to the Fund. In our preferred methodology, Fund A reports physical assets as contributing to leverage and therefore shows a leverage number of 100%, Fund B under the 'sum of the notionals' reports 100% alongside the VaR and the fund's alternative leverage measure. Under our approach, the investor gains better insight into the risks within their investment and the results are more consistent with the risks undertaken.

In addition, AI recognizes that exclusion may contribute to undesirable outcomes. As an example, assume on day 1 there are two investors in Fund A who each invest $500 and the fund buys a 'knock-out' (In this example a knock-out call refers to an option which becomes worthless if it reaches a certain value; please see the appendices for a graphical explanation of the return of a knock out option. This option may be referred to differently by otherwise, for example as a 'one-touch' however, the principles remain the same. In this case an investor might buy a knock-out option because it is cheaper than a standard call and the investment manager does not believe the S&P will rally by more than 900 points during the life of this option.) call on the S&P 500 a thousand points above the current level.

Under the current proposal, the fund has zero leverage. Suppose at the end of day 1, the S&P has rallied 900 points and Fund A's value has risen to $2,000. At the start of day 2, one of the two investors decides to sell just as a new investor decides to enter the fund, and the existing investor gets $1,000 back. At the end of day 2, the S&P remains unchanged from its previous level and the fund is still worth $2,000. On day 3, the S&P surges again and rises 200 points therefore 'crossing the barrier'(Crossing the barrier refers to when the price of the underlying rises beyond the level of the 'barrier', at the point when it crosses the barrier the option becomes worthless.) and knocking out the option. As a result of passing the 'barrier', the option is now worthless and the investors in the fund have lost all the value of the fund despite showing a leverage of zero.

Under the current proposal, the new investor could well feel that they were not adequately protected. However, under AI's suggested approach, the leverage would have been reported as 100% for the sum of the notionals and the Fund VaR on day 2 would have displayed the level of potential risk as a result of being so close to the barrier – meaning the investors would have been better able to understand that they could lose all their investment. Furthermore, we agree that rules which might be considered too restrictive could lead to product innovations that create more opaque and complex instruments, thus creating new challenges for CSA and for risk and compliance managers. Most derivatives, such as swaps, futures and options are now well understood by the market place. Coupled with this more sophisticated knowledge is increased regulatory oversight and support which has produced better protection for investors.

Question 12;
We have no comments on question 12.

Question 13;
We have no comments on question 13.

Question 14;
We suggest the CSA considers extending the same flexibility to funds already using the VaR approach similar to UCITS, conditional upon meeting additional controls such as back testing. We understand some may have concerns regarding the reliability of using relative or absolute VaR as the only investment risk limit. However, we believe a significantly higher notional guideline with an approval on a fund-by-fund approach, coupled with an absolute VaR (limited to 20% common) or relative VaR (limited to two times a suitable benchmark) similar to UCITS funds achieves a better balance between providing flexibility regarding the use of derivatives while limiting the potential risks associated with leverage. The fund may also be asked to meet the following requirements:

1. Back testing: Monitor VaR overshootings on a daily basis. Defined as when the one-day change in the fund's value exceeds the related one-day VaR measure at 99% confidence level calculated by the VaR model. On a semi-annual basis, the fund manager informs the applicable regulator if the number of overshootings for the most recent 250 business days exceeds 4.

2. Stress testing: Run stress testing for a comprehensive range of scenarios reflecting possible market conditions relevant to the fund.

3. Independent model validation: Engage a party independent of the building of the model, or suitable skilled third parties such as public accounting firms to validate the VaR model.

4. Control Assurance: Key operational and governance controls related to the VaR model validation and counterparty risk management framework must be independently examined in an annual Type 2 SOC 1 report, or its equivalent.

Providing such flexibility will also bring the following benefits to the industry and investors:

1. Incentivizing the Canadian mutual fund industry to quickly build its risk management capability based on existing guidelines approved by European regulators and widely adopted in Europe.

2. Improving Canadian fund industry's competitive position when compared to their international peers.

   Aviva Investors – along with many large and sophisticated asset managers who manage to their client's best interests across the globe – is familiar with the UCITS structure, which has become widely recognized not just in, but also beyond the European Union. As such, we believe that the introduction of VaR based restrictions is not a significant challenge for large managers operating in the Canadian market place.

   With regards to the relative VaR restrictions, which we suggest can be up to two times the benchmarks similar to UCITS, we believe that the investment manager is best placed to choose a suitable reference benchmark which should be clearly disclosed to investors and approved by the fund manager. While in the majority of cases there is no complexity in deciding on the suitable benchmark for a relative VaR calculation, AI recognizes that in some cases the choice maybe less clear cut. However, the investment manager should be able to demonstrate that the appropriate consideration was applied to the decision and that the disclosure to the investors is fair and transparent. In the case of absolute VaR, we believe that 20% (similar to the restriction in UCITS) is an appropriate maximum level of risk. While these are the upper restrictions for a fund, we believe that the investment manager should operate with a lower guideline level of VaR which more accurately reflects the investment manager's expectations of risk. This guideline may be amended from time to time through an appropriately controlled approach. Likewise, the manager's risk management process should indicate clearly the approach when an excess occurs (passive or active breaches may have separate treatments).

Question 15;
We have no comments on question 15.

3. **Question 16;**
   The period required to adjust to the changes will be determined by the final implemented changes, and we would encourage the CSA to allow for sufficient time to be provided to allow for this transition.

   In addition to our responses to the specific questions raised by the CSA, there are a couple of additional points that we would like to make.

If an alternative fund under the final rules will be required to have an investment objective that refers to certain asset classes or financial instruments, then existing investment funds that were established under the current regime should be grandfathered to avoid the need to obtain investor approval for a change in investment objective in order to comply with this definition. We would also suggest that these existing funds be grandfathered with respect to the new leverage limit, as otherwise their investment strategies may need to be significantly altered and they may be unable to achieve their investment objective.

AI believes that the proposal will significantly alter the landscape of alternative fund offerings in Canada. Generally speaking, AI supports the position that Canadian investors should have access in Canada to the same types of products as investors in other regulated countries, such as the U.S. and Europe. We would be happy to meet with CSA staff, either in person or by phone, to discuss our comments and suggestions in greater detail.

Compliance Department
225 West Wacker Drive, Suite 2250
Chicago, IL 60606

2016-0555_AIC_December 2016_CSA Comments

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SEC PROPOSED RULE 18F-4

Aviva Investors Comments

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AVIVA INVESTORS COMMENTS

AVIVA INVESTORS COMMENTS

Introduction

Aviva Investors appreciates this opportunity to comment on the proposed rule 18f-4. Our strategy is to be a Global Leader in outcome oriented solutions, and **we strongly believe that embedding risk management at the heart of the investment process is the most effective way to deliver clients the outcomes that they are seeking**. As a large global asset management firm with experience operating funds across many different regulatory regimes, we offer our insights and thoughts on the proposed rule. **Aviva Investors shares the Commission's view on the importance of higher standards of risk management and increased Fund Board supervision**. Many of the proposals, such as the use of Value at Risk (VaR), and documented Risk Management Programs (RMPs) have operated successfully in a number of markets and we clearly support these.

In the proposal, the Commission sought answers from industry participants. Aviva Investors ("AI") has sought to address those questions based on our experience and knowledge. AI believes that investors typically have one of a small number of outcomes that they want to achieve with their investments: achieving capital growth, beating inflation, meeting a defined liability and generating income. These outcomes may appear simple on the surface; nonetheless we recognize that markets do not always rise, and simplistic long only funds may not deliver on these outcomes. Hence, **AI is clear that investors are best served by having access to a range of well-controlled investment strategies.** As a result, restrictions such as those proposed in 18f-4 need to balance the goals of investor protection against the merits of derivatives usage in the investment strategy undertaken on their behalf. AI believes that this can be achieved through a combination of principle based regulation and more prescriptive measures. We set out our detailed thoughts in the letter below.

Part 1: Comments on the proposed exposure calculation methodology:

SEC Question 1 (1st bullet on Page 84): Is the proposed rule's use of notional amounts as the basis for calculating a fund's exposure under a derivatives transaction appropriate? Does the notional amount of a derivatives transaction generally serve as an appropriate means of measuring a fund's exposure to the applicable reference asset or metric? Are there particular types of derivatives transactions or reference assets for which the notional amount would or would not be effective in this regard? For such derivatives, what alternative measures might be used and why would they be more appropriate? Would such alternative measures be easier for funds and compliance staff to administer?

Response by Aviva Investors: We agree with the Commission that the notional amount of derivatives may not be an appropriate measure of risk. Indeed, in some cases, it may well be *at best* unhelpful and *at worst* mislead clients as to the true level of risk they are employing in their investments[1] .

AI does not believe that a single methodology exists at present to accurately explain fund leverage, and therefore any purely prescriptive approach will unfairly penalize some investment strategies. This does not imply that the approach presented in the proposal is without merit but instead recognizes that there are flaws in any approach and that these should be compensated for where possible.

We support the Commission in seeking to highlight to clients where and when leverage is being used and particularly where it can magnify the risks of an investment. However, we believe that the term leverage needs to be clearly defined. Generally speaking, leverage can be achieved through the use of borrowing cash to reinvest or via the use of derivatives. In the former case we agree with the Commission that clients should be clearly informed, or possibly better protected, by a tight restriction on borrowing. **In line with this, we would suggest the Commission introduces a fund level restriction of 10% for borrowing which should be temporary in nature to facilitate short-term cash management and fund liquidity.**

The second instance where leverage can be achieved is through the use the financial instruments generally referred to as derivatives. We believe that the generation of 'leverage' through this means should be clearly

[1] Some simple examples of which are illustrated in the supporting documents that AI has supplied with its responses to the Commission's proposals.

disclosed to investors by the investment company and that suitable controls should be in place to measure, monitor and control the use of this leverage. AI believes that the establishment of the RMP is a vital component of this process and that this document should clearly state the mechanisms through which the controls operate. A vital component of this control should be a clearly stated and explained methodology for calculating leverage. We believe the majority of the proposal is in line with other globally observed practices and shares their collective strengths and weaknesses. **We would encourage the Commission to consider that 'physical' assets should carry leverage within the calculation; hence the base leverage for all funds is 100%**. We propose that this is a fairer representation of the risk and also avoids the pitfall of a derivative only replication position appearing more risky than the equivalent investment in assets. Indeed, there is much supporting evidence to suggest that in the case of synthetic replication the investment might well have better risk and return characteristics.

In answer to the question raised by the Commission as to instruments where notional was less suitable to measuring the risks involved, **we believe that the current proposal unfairly penalizes Fixed Income and FX risk relative to Equites.** For example, on the basis of the current calculation a $1million of equity notional has the same leverage as $1million of Fixed Income or FX notional irrespective of the levels of volatility and hence risk. This can be illustrated through the examples in the supporting appendices which demonstrate that, in many cases, the risk of Fixed Income investments can be substantially lower than the equivalent level of Equity investments. As a result, we feel that the 'sum of the notionals' approach may unfairly generate an expectation that the level of risk is the same to the end client. **We would suggest that in the case where the Commission prefers to stick with the simplicity of the proposed calculation that they grant a significantly higher level of leverage** and that they pass the responsibility to the Fund Board to set an appropriate level of leverage in line with the Fund's investment objective under that threshold. In order to facilitate this, we believe that the Investment Company should publish the maximum level of expected leverage to the investors in the prospectus and, during the production of required investor information, include the level of leverage as of the appropriate date in said information. Furthermore, the Fund Board should ensure that they are comfortable that the investment manager is capable and skilled in the use of the derivatives deployed in pursuit of the investment objective.

As a result of the aforementioned weaknesses in the assumption of the equivalence of risk between investments, **we believe a suitable alternative should be employed by the Investment Manager.** This should take into account the risks of the underlying investment from a market risk perspective. The Fund may use this definition if the Fund Board considers it suitable and appropriate public disclosures on the methodology have been provided to the investors.

1. **Interest Rate 'sensitive' products:** We suggest that swaps/futures/interest rate sensitive products[2] could be expressed as a 'delta' equivalent of the risk-free 10-year bond. For example, a fund buying USD swaps can equate the risk of that position through IR01[3] to the equivalent amount of the 'generic/on the run' 10-year US Treasury.
2. **Foreign Exchange 'sensitive' products:** We suggest that FX sensitive products could be expressed as a 'delta'[4] equivalent. This is for either leg of the currency pair and should be expressed as an amount of the base currency of the fund.
3. **Credit Spread 'sensitive' products**: In line with the suggestion with regards to Interest Rate sensitive products, we believe an acceptable approach would be to measure the equivalence on a CS01[5] basis', which could be combined with the IR Delta.

[2] An interest rate sensitive product should primarily have 'sensitivity' to changes in the price of the underlying rate curve.
[3] IR01 being defined as the interest rate sensitivity to a 1bp change in the underlying 'risk-free' curve, this may be referred to as IR Delta or Delta amongst other terms in the industry.
[4] FX Delta being defined as the sensitivity to a 1% change in the underlying currency.
[5] CS01 being defined as the credit spread sensitivity to a 1bp change in the underlying credit curve; this may be referred to as CS Delta.

Where a product contains more than one type of risk, all relevant risks should be included in the exposure calculation. Where CS01 & IR01 are applicable, the larger of the two must be included. While we acknowledge that this approach has some shortcomings, it may represent a more accurate picture of leverage to the underlying investor.

Regardless of the approach taken, be it a simple 'sum of the notionals' or the approach described above, **AI believes that transparency is in the client's best interest,** and hence a practical example of how each instrument in the portfolio is being handled should be publicly available for investors to review. While the approach described above improves the accuracy of the calculation for the investor in the fund, we agree that this does not make it possible for funds to be compared between providers with different approaches. Therefore, **if the fund chooses to utilize its own definition of leverage, a 'sum of the notionals' leverage total should be disclosed along with the level of fund VaR.** In the case of VaR, it is our thought that the investor disclosure documents should also contain a 'plain English' explanation of the term VaR[6]. As the 'sum of the notionals' approach is clearly understood, the requirement to calculate VaR would be in place and the fund would be able to define leverage accordingly. We do not believe this approach would likely place an onerous load on the compliance and risk staff of the Investment Company. However, we recognize that this 'triple-lock' approach to the disclosure requirements means that funds and their managers will have to invest in suitably skilled, trained and experienced experts, thereby increasing the level of protection that clients can reasonably expect.

SEC Question 2 (3rd bullet on Page 89): Should the calculation of exposure be broadened to include not only derivatives that involve the issuance of senior securities (because they involve a payment obligation) but also derivatives that would not generally be considered to involve senior securities, such as purchased options, structured notes, or other derivatives that provide economic leverage, given that such instruments can increase the volatility of a fund's portfolio and thus cause an investment in a fund to be more speculative than if the fund's portfolio did not include such instruments?

Response by Aviva Investors: We advise the Commission to include all instruments held within a portfolio for the purpose of leverage calculations**.** We believe that physical and synthetic instruments introduce the same portfolio risks and therefore should be treated equally for the purposes of leverage calculations**. We also believe that both purchased options and sold options should be included in leverage calculations.** While the exclusion of purchased options would seem outwardly appealing to many, we believe this is merely because it reduces the leverage calculation as opposed to it having merit from a risk management perspective.

We can demonstrate through an example. If an investor wishes to replicate the S&P 500 index they may buy every share in the index to generate the exposure in Fund A or they could choose to buy a call and sell a put which will give them the same 'exposure'[7] in Fund B. In the current proposal, only one leg of the transaction is included towards leverage, the sold put within Fund B because physical asset purchases are excluded as are purchased options which misleads the investors in Fund B and misrepresents the risk to the Fund. In our preferred methodology, Fund A reports physical assets as contributing to leverage and therefore shows a leverage number of 100%, Fund B under the 'sum of the notionals' reports 100% alongside the VaR and the fund's alternative leverage measure. Under our approach, the investor gains better insight into the risks within their investment and the results are more consistent with the risks undertaken.

Furthermore, **AI recognizes that exclusion may contribute to undesirable outcomes.** As an example, assume on day 1 there are two investors in Fund A who each invest $500 and the fund buys a 'knock-out'[8] call on the S&P

[6] We agree with the Commission's proposal for a 1mth 99% VaR using not less than 2 yrs of market data (where available or with a suitable substitute if actual market data is not available). In the case where non-linear risk is taken (such as in the case of using options) the VaR model is required to account for that such as through the use of Monte Carlo simulation or full-revaluation Historical Simulation. Parametric VaR would only be considered suitable in the case where-in the risk is 'linear' in nature, should the Investment Company wish to deploy a modified Parametric VaR approach it must demonstrate that the majority of the non-linear risk is modelled within the system.

[7] Exposure here is defined as the financial impact from a change in the value of the S&P.

[8] In this example a knock-out call refers to an option which becomes worthless if it reaches a certain value; please see the appendices for a graphical explanation of the return of a knock out option. This option may be referred to differently by otherwise, for example as a 'one-touch' however the principles

500 a thousand points above the current level. Under the current proposal, the fund has zero leverage. Suppose at the end of day 1, the S&P has rallied 900 points and Fund A's value has risen to $2,000. At the start of day 2, one of the two investors decides to sell just as a new investor decides to enter the fund, and the existing investor gets $1,000 back. At the end of day 2, the S&P remains unchanged from its previous level and the fund is still worth $2,000[9]. On day 3, the S&P surges again and rises 200 points therefore 'crossing the barrier'[10] and knocking out the option. As a result of passing the 'barrier', the option is now worthless and the investors in the fund have lost all the value of the fund despite showing a leverage of zero. **Under the current proposal, the new investor could well feel that they were not adequately protected.** However, under AI's suggested approach, the leverage would have been reported as 100% for the sum of the notionals and the Fund VaR on day 2 would have displayed the level of potential risk as a result of being so close to the barrier – meaning the investors would have been better able to understand that they could lose all their investment.

Furthermore, **we agree that rules which might be considered too restrictive could lead to product innovations that create more opaque and complex instruments**, thus creating new challenges for the Commission and for risk and compliance managers. Most derivatives, such as swaps, futures and options are now well understood by the market place. Coupled with this more sophisticated knowledge is increased regulatory oversight and support which has produced better protection for investors.

Should the Commission feel that our suggested approach is not a more suitable route, **we would like further clarification on some of the details of the proposals as whether purchased options such as swaptions should be included** in the calculation of exposure and/or a VaR test used to determine if the fund qualifies for the 300% risk-based limit. The working assumption that the market would rely on is that these instruments should be excluded from both calculations at the time of purchase, but on exercise they would convert to a standard underlying derivative transaction. Clarification by the SEC on such detail would assist the market in understanding the scope of the proposals, and as such, it would be of significant assistance.

SEC Question 3 (1st bullet on Page 90): Do commenters agree that it is appropriate to include exposure associated with a fund's financial commitment transactions and other senior securities transactions in the calculation of the fund's exposure for purposes of the 150% exposure limit in the exposure-based portfolio limit (and the 300% limit under the risk-based portfolio limit), as proposed, so that the exposure limit would include the fund's exposure from all senior securities transactions? Should we, instead, include only exposure associated with a fund's derivatives transactions but reduce the exposure limits so that a fund that would rely on the exemption provided by the proposed rule would be subject to a limit on leverage or potential leverage from all senior securities transactions? If we were to take this approach should we, for example, reduce the exposure limits to 50% in the case of the exposure-based portfolio limit and 100% in the case of the risk-based limit?

Response by Aviva Investors: We agree with the Commission that it is necessary to have a single combined exposure limit applicable to the aggregate of all transactions that generate exposure, regardless whether the exposure is generated through financial commitment transaction, derivative transactions or other senior securities transactions. It appears the proposal does not specify the borrowing limit as a result of other senior securities transactions under the new rule. As previously discussed in this response to the Commission's proposals, **our preference is a more nuanced approach to the setting of leverage restrictions and the separation of borrowing to create leverage *versus* the use of derivatives**. Should the Commission accept our proposed refinements, we believe this could also allow for a reduction of the restrictions on borrowing to a significantly lower level.

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remain the same. In this case an investor might buy a knock-out option because it is cheaper than a standard call and the investment manager does not believe the S&P will rally by more than 900 points during the life of this option.

[9] In this example the numbers are only hypothetical and do not represent the true change in value, it is merely used for the purpose of illustration.

[10] Crossing the barrier refers to when the price of the underlying rises beyond the level of the 'barrier', at the point when it crosses the barrier the option becomes worthless.

Part 2: Comments on the proposed 150% exposure limit:

SEC Question 4 (2nd bullet on Page 107): The 150% exposure limit (and the 300% exposure limit in the risk-based portfolio limit) would apply to all funds without regard to the type of fund or the fund's strategy. Are there certain types of funds for which a higher or lower exposure limit would be appropriate?

Response by Aviva Investors: While we applaud the goal of the SEC to improve investor protection from inappropriate levels of risk, **we believe the exposure limit as proposed does not provide sufficient flexibility to some low risk funds, such as outcome oriented funds which use derivatives to achieve return objectives and low volatility.** These are commonly referred to as liquid alternative funds. The proposed risk-based limit heavily restricts the use of derivatives to transactions which are classically referred to as 'hedges'. Hedges are trades, typically through derivatives, which specifically reduce market risk. However, the proposals as currently crafted restrict the use of derivatives to construct significantly more robust portfolios, and therefore, may worsen the outcomes that clients receive. **We believe using derivatives to gain exposure does not inherently increase the risk of the fund since derivatives and physical assets display similar return and risk characteristics**. See **Exhibit 3** for an example which demonstrates Treasury bonds and its swap displaying identical price movement throughout a 20-year period spanning across multiple market cycles. With proper risk controls, using derivatives to gain exposure has certain benefits as listed below, and therefore, should not be penalized compared to those funds using derivatives as a hedging tool in a traditional sense:

1. Derivatives may allow funds to gain unique exposures that physical assets cannot provide. As a result, they may provide better diversification than traditional balanced portfolios, especially during stressed market conditions when volatility for physical assets, such as stocks and bonds, tends to go up simultaneously as shown in **Exhibits 1 and 2**. Please see **Exhibit 4** for an example demonstrating how swaps can gain exposure to certain spots on the yield curve when there are no physical bonds with maturity dates between November 23 and February 22.
2. Derivatives, if deployed properly, offer better liquidity than many physical assets, especially credit-fixed income. Regulatory changes in the banking industry since the financial crisis have reduced the number and scale of market makers. Better liquidity provided by derivatives allows fund managers to increase and decrease exposure more quickly, which is critical for risk management purposes.
3. There are certain asset classes, such as FX, where the bulk of the market is OTC and derivative.

As a result**, we suggest the Commission considers extending the same flexibility to funds already using the VaR approach similar to UCITS, conditional upon meeting additional controls such as back testing.**

We appreciate the Commission's concerns regarding managed futures funds and leveraged ETFs, which pursue their strategies almost exclusively through significant derivative use and sometimes leverage. **However, the proposed exposure limit at 150% appears to cause issues for other liquid alternatives and fixed income funds that use derivatives to achieve a wide array of client outcomes.** The preliminary results from a more recent ICI survey in which we participated indicate that the proposed exposure limit only impacts alternative funds, but also taxable bond funds as classified by Morningstar. The ICI survey appears to present different results from the study conducted by DERA staff, which shows only 1% of the sample funds with exposure over 150%. One possible explanation, in our view, is the timing of the DERA study. While ICI's survey was done in early 2016, the DERA study was based on late 2014 data collected through Form N-CSR. Because the **market conditions were much more favorable in late 2014, many funds did not need to use derivatives extensively to manage volatility at the time of DERA study**; however, their derivatives usage has increased significantly as market volatility continues to rise for both bonds and stocks as shown in **Exhibits 1 and 2**. In addition, we note that many mutual funds did not use derivatives at the time of DERA study even though the prospecti of the funds indicate they are allowed to do so. For example, the white paper from DERA indicated that 77% of all funds that completed Form N-SAR for 2014 have investment policies that allow the use of equity options, but only 6% reported that they have actually used equity options during the reporting period. **We believe this itself may support the notion that derivatives usage by mutual funds will go up from the low point in late 2014 since most mutual funds retain that flexibility for good reason.**

Without providing sufficient flexibility to mutual funds to deploy derivatives, there may be unintended negative impacts to investors such as the following:

1. Force a greater concentration of mutual fund assets into long-only strategies that are increasingly susceptible to market volatility and liquidity risk, and may be more susceptible to suffering negative total returns.
2. Drive demand for offshore funds which will continue to access derivative strategies. Although many retail investors don't have direct access to offshore vehicles, a review of shareholder information for certain large alternative funds indicates that many large shareholders of these funds are institutional vehicles with retail assets such as pension funds. The demand for stable return and low volatility may force those pension funds to increasingly rely on offshore vehicles such as those in Cayman Islands and British Virgin Islands, **which places US mutual funds at a significant competitive disadvantage for institutional clients and denies retail clients access to many suitable or indeed superior products**.

Part 3: Comments on the proposed VaR test:

SEC Question 5 (1st bullet on Page 132): For the purposes of the risk-based portfolio limit, should the proposed rule use an approach such as (or similar to) the relative VaR or absolute VaR approach for UCITS funds, instead of or as an alternative to the proposed VaR test? Why or why not? Would it be more efficient to allow funds to use such an approach – e.g., because some advisers already use this approach for UCITS funds? Under a relative VaR approach, what sort of benchmarks would or would not be appropriate, and how should the benchmarks be chosen? Under an absolute VaR approach, what would be an appropriate VaR limit (e.g., 20%, as for UCITS funds, or a higher or lower limit)? Would a relative VaR or absolute VaR approach appropriately address the undue speculation concern underlying section 18? Why or why not?

Response by Aviva Investors:
We understand some of the Commission's concern regarding the reliability of using relative or absolute VaR as the only investment risk limit. However, **we do believe a significantly higher notional guideline with an approval on a fund-by-fund approach, coupled with an absolute VaR (limited to 20% common) or relative VaR (limited to two times a suitable benchmark) similar to UCITS funds achieves a better balance between providing flexibility regarding the use of derivatives while limiting the potential risks associated with leverage.** The fund may also be asked to meet the following requirements:

1. **Back testing:** Monitor VaR overshootings on a daily basis. Defined as when the one-day change in the fund's value exceeds the related one-day VaR measure at 99% confidence level calculated by the VaR model. On a semi-annual basis, the fund manager informs the Commission if the number of overshootings for the most recent 250 business days exceeds 4.
2. **Stress testing:** Run stress testing for a comprehensive range of scenarios reflecting possible market conditions relevant to the fund.
3. **Independent model validation:** Engage a party independent of the building of the model, or suitable skilled third parties such as public accounting firms to validate the VaR model.
4. **Control Assurance**: Key operational and governance controls related to the VaR model validation and counterparty risk management framework must be independently examined in an annual Type 2 SOC 1 report, or its equivalent, and the examination must be conducted by a Certified Public Accounting firm subject to regular inspection by the PCAOB.

Providing such flexibility will also bring the following benefits to the industry and investors:

1. Incentivizing the US mutual fund industry to quickly build its risk management capability based on existing guidelines approved by European regulators and widely adopted in Europe.
2. Improving US fund industry's competitive position when compared to their international peers.

Aviva Investors – along with many large and sophisticated asset managers who manage to their client's best interests across the globe – is familiar with the UCITS structure which has become widely recognized not just in but

beyond the European Union. As such, **we believe that the introduction of VaR based restrictions is not a significant challenge for large managers operating in the US market place.**

With regards to the relative VaR restrictions, which we suggest can be up to two times the benchmarks similar to UCITS, **we believe that the investment manager is best placed to choose a suitable reference benchmark which should be clearly disclosed to investors and approved by the Fund's board.** While in the majority of cases there is no complexity in deciding on the suitable benchmark for a relative VaR calculation, AI recognizes that in some cases the choice maybe less clear cut. However, the investment manager should be able to demonstrate that the appropriate consideration was applied to the decision and that the disclosure to the investors is fair and transparent. In the case of absolute VaR, we believe that 20% (similar to the restriction in UCITS) is an appropriate maximum level of risk. While these are the upper restrictions for a fund, we believe that the investment manager should operate with a lower guideline level of VaR which more accurately reflects the investment manager's expectations of risk. This guideline may be amended from time to time through an appropriately controlled approach. Likewise, the manager's risk management process should indicate clearly the approach when an excess occurs (passive or active breaches may have separate treatments).

As discussed above, we believe that the current proposed restriction of 150%/300% leverage may prevent investors from achieving their outcomes. Instead, we believe that the approach of utilizing a VaR based restriction as described above is more appropriate. Moreover, we respectfully suggest that the investment manager should disclose in their fund's disclosure documentation the maximum expected leverage. While this may not constitute a limit, it would be expected that the manager should not exceed this disclosed level in the normal course of management, and higher levels of leverage should only occur for short periods of time.

SEC Question 6 (1st bullet on Page 152): The proposed rule would not require a fund to terminate a derivatives transaction if the fund complied with the applicable portfolio limitation immediately after entering into the transaction, even if (for example), the fund's net assets later declined with the result that the fund's exposure at that later time exceeded the relevant exposure limit. Do commenters agree that this is appropriate? Conversely, should we instead require a maintenance test for notional amounts such that funds would be required to adjust their derivatives transactions if the exposure exceeds 150% of net assets for longer than a certain period of time, even if the fund has not entered into any senior securities transactions? If so, should we consider including a cushion amount – for example, by only requiring a fund to adjust its positions if its exposure reaches a higher level, such as 175%? Should we limit the time period (e.g., to 30 days, 60 days, or 90 days) in which an exposure could exceed 150% of net assets (or 300% under the risk-based portfolio limit) as a result of changes in the fund's net assets so that a fund cannot persistently exceed the rule's exposure limits? Would such an approach better promote investor protection? Would there be operational challenges with this requirement?

Response by Aviva Investors: We do not believe it is necessary to expand the notional amount test beyond the time of entering the derivative transactions.

Part 4: Summary of our recommendations:

In summary, we suggest the Commission considers the following five adjustments:

1. **Permitting the use of an absolute VaR limit of 20%** (or two times) an appropriate reference benchmark as an option to restrict a fund's leverage, if the fund complies with control requirements such as back testing as outlined in our response to Question 5 above.
2. **Normalizing the notional amount for derivatives by calculating them in 'delta' equivalent** of the underlying investment exposure. For example, normalizing the notional amount for all interest rate swaps and futures by calculating them in terms of the10-year bond equivalent.
3. Requiring an investment fund to supply in its public documents all appropriate data with regards to the maximum notional leverage use. **This can be greater than the 300% proposal.**
4. Restricting the amount a fund can borrow through other senior s**ecurities transactions to 10% of the fund's NAV and only permitting** such borrowing in temporary nature to facilitate short term cash management and fund liquidity.
5. Requiring the Fund Board to approve the Risk Management Process of the fund including its use of VaR, leverage and the limits for these.
6. Excluding the fund's base currency leg of the contract when calculating notional amount for FX forwards and futures.

We believe making the aforementioned adjustments will bring the following benefits to the industry and to investors:

1. Incentivizing the US mutual fund industry to quickly build its risk management capability based on existing guidelines approved by European regulators and widely adopted in Europe.
2. Improving US fund industry's competitive position when compared to their international peers.

In addition, we would like to seek clarification on whether purchased options such as swaptions should be included in the calculation of exposure and/or a VaR test used to determine if the fund qualifies for the 300% risk-based limit. The working assumption that the market would rely on is that these instruments should be excluded from both calculations at the time of purchase, however, on exercise they would convert to a standard underlying derivative transaction.

We appreciate the Commission's consideration of our recommendations. Please do not hesitate to reach out to **Sean Brumble Chief Operating Officer at Aviva Investors Americas** if you have any additional questions or would like to discuss our views further.

Sincerely,

Sean Brumble, Chief Operating Officer
Aviva Investors Americas
225 West Wacker Dr. Suite 1750
Chicago, IL 60606
312.873.5819
sean.brumble@avivainvestors.com

Exhibit 1: S&P 500 Index (Historical Volatility)

S&P 500 Index (Implied Volatility)

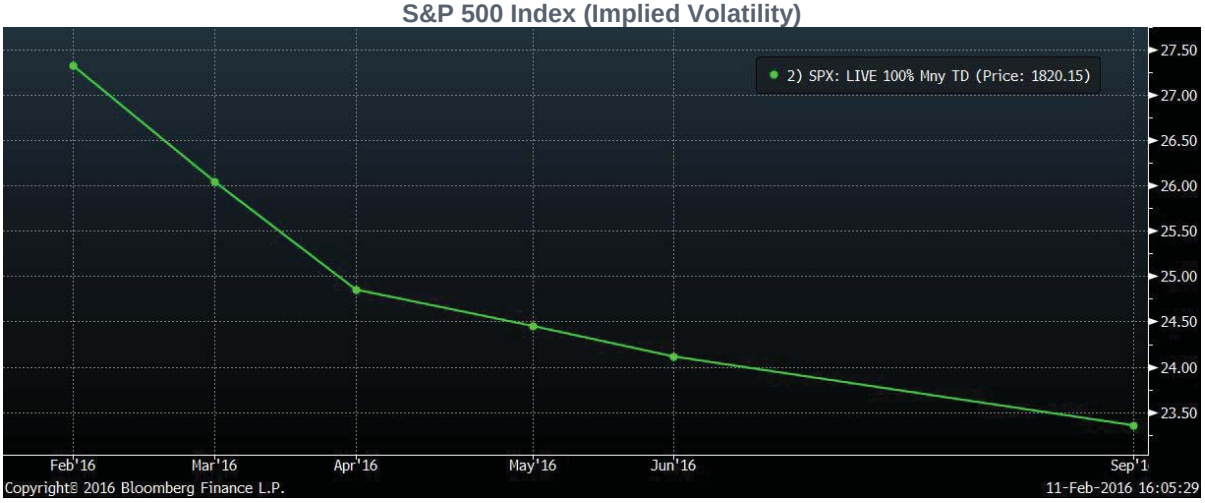


Exhibit 2: Barclays US Aggregate Bond Index (Historical Volatility)

Exhibit 3: 10Y Treasury Yield vs. 10Y Swap Rate

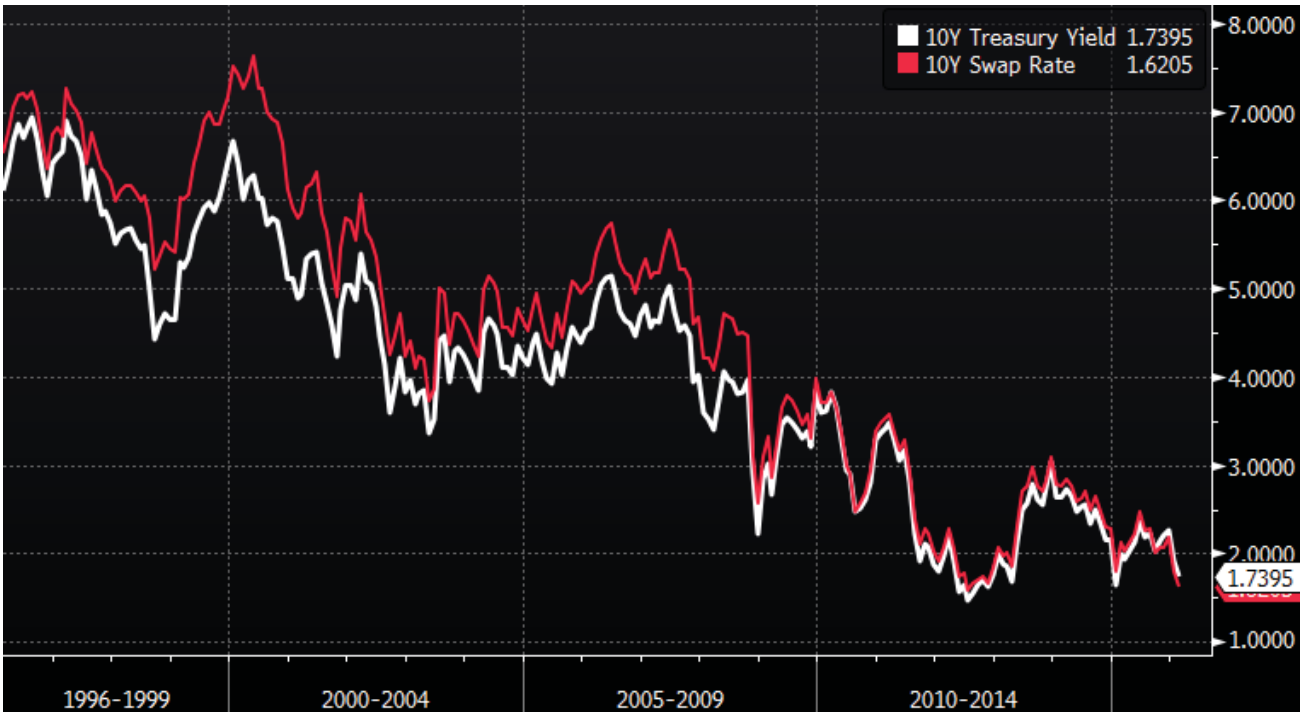
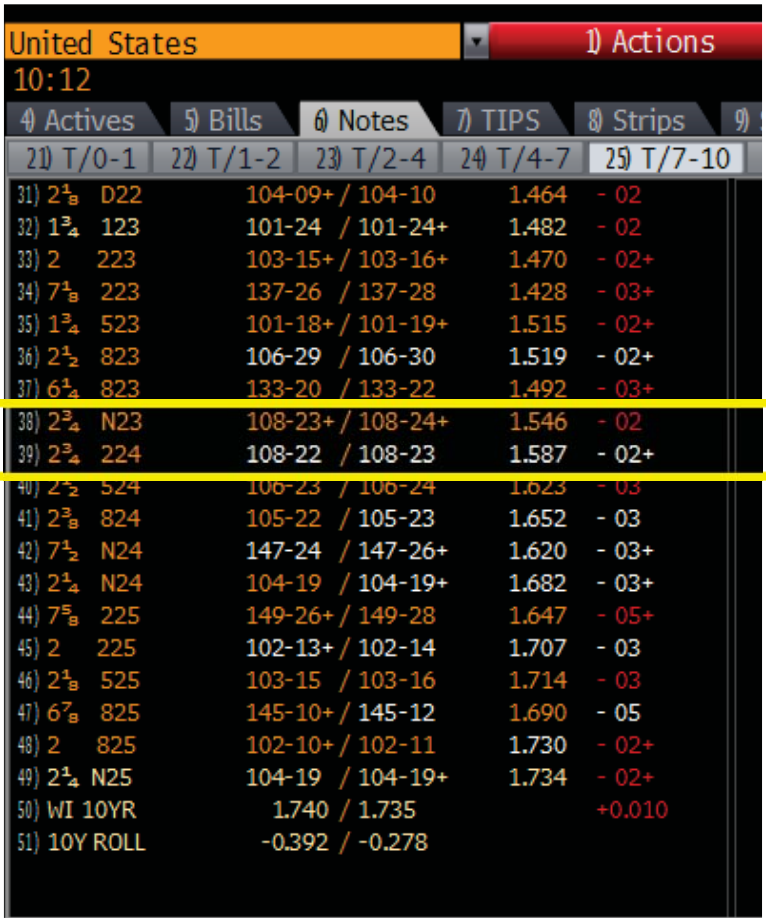
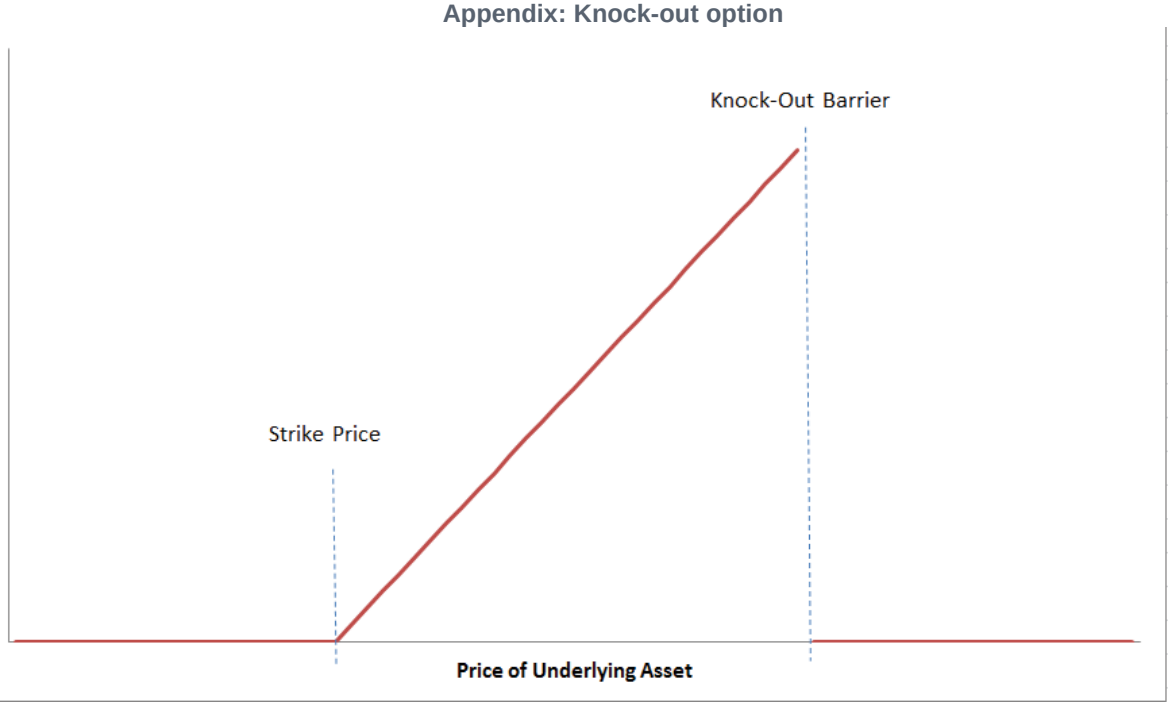


Exhibit 4: Using swaps to gain exposure on yield curve that physical bonds cannot provide



Appendix: Knock-out option



Strike	K.O.	
50	80	
30	-	
40	-	
50	-	
60	10.00	
70	20.00	
75	25.00	
79	29.00	
80		0.000001
90		0.000001
100		0.000001

AVIVA INVESTORS COMMENTS

INVESTMENT COMPANY INSTITUTE

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July 28, 2016

Mr. Brent J. Fields
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

Re: *Use of Derivatives by Registered Investment Companies and Business Development Companies* (File No. S7-24-15)

Dear Mr. Fields:

I am writing on behalf of the Investment Company Institute[1] and our members to provide additional comments on the Securities and Exchange Commission's proposed rule for funds' use of derivatives.[2] Specifically, we recommend that the Commission revise the proposed rule's portfolio limit tests to provide a simple and effective risk-adjustment schedule for calculating the notional amount of a derivative instrument. Figure 1 below provides the specific schedule we recommend.

Our recommended schedule takes appropriate account of the risk of different types of derivatives and is a far superior methodology than mere reliance on gross notional exposure. The schedule is based on well-founded risk determinations that prudential and other regulators have made for very similar purposes, and is easy to administer. It also should satisfy the Commission's stated goal of limiting undue speculation through funds' use of derivatives.[3]

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[1] The Investment Company Institute is a leading, global association of regulated funds, including mutual funds, exchange-traded funds ("ETFs"), closed-end funds, and unit investment trusts in the United States, and similar funds offered to investors in jurisdictions worldwide. ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. ICI's U.S. fund members manage total assets of $17.9 trillion and serve more than 90 million U.S. shareholders.

[2] *Use of Derivatives by Registered Investment Companies and Business Development Companies*, Release No. IC-31933, 80 Fed. Reg. 80884 (Dec. 28, 2015), available at https://www.gpo.gov/fdsys/pkg/FR-2015-12-28/pdf/2015-31704.pdf.

[3] *See* proposing release at 80901 (portfolio limits are designed primarily to address undue speculations concerns).

Immediately following the schedule below, we explain briefly how we envision funds will use the schedule in connection with the recommendation in our March letter that the limits be revised to 200 percent (for the exposure-based portfolio limit) and 350 percent (for the risk-based portfolio limit).[4] We then explain why we believe the SEC should adopt the schedule.

Figure 1 – ICI's Recommended Derivatives Risk-Adjustment Schedule[5]

Underlying Asset Category	Risk Adjustment to Notional Amount
Equity	x 100%
Commodity	x 100%
Foreign Exchange / Currency	x 40%
Cross Currency	
0–2 year duration	x 6.7%
2–5 year duration	x 13.3%
5+ year duration	x 26.7%
Interest Rate	
0–1 year duration (adjusted to a 12-month period)*	x 6.7%
1–2 year duration	x 6.7%
2–5 year duration	x 13.3%
5+ year duration	x 26.7%
Credit / Debt	
0–2 year duration	x 13.3%
2–5 year duration	x 33.3%
5+ year duration	x 66.7%
All Other	x 100%

* Funds would adjust interest rate derivatives with less than a one-year maturity to a 12-month period prior to applying the risk-adjustment multiplier. For example, a fund would divide the notional amount of a 90-day instrument by four before multiplying it by the 6.7 percent risk-adjustment multiplier.

[4] This letter supplements comments we submitted to the SEC in March. *See* Letter from David W. Blass, General Counsel, Investment Company Institute, to Brent J. Fields, Secretary, Securities and Exchange Commission, dated March 28, 2016, available at https://www.sec.gov/comments/s7-24-15/s72415-114.pdf. We continue to urge the SEC to adopt the recommendations in our March letter. We recommended a risk-adjusted 200 percent exposure-based limit (in place of the proposed 150 percent limit) and 350 percent risk-based limit (in place of the 300 percent limit). We also continue to recommend excluding financial commitment transactions from the portfolio limits and excluding from the portfolio limits the following types of direct hedging transactions: 1) currency derivatives that provide short exposure to a currency in which a security held by the fund is denominated, and the short exposure does not exceed the value of the security; 2) written call options on securities held in the fund's portfolio; and 3) a purchased single-name credit default swap that provides credit protection on the issuer of a security held by the fund with gross notional exposure that does not exceed the principal amount of the security.

[5] Appendix A provides an annotated version of the schedule, including examples of instruments that fit within each asset category. Appendix B provides a chart showing how the risk-adjustment factor for each category was determined.

1. How Funds Will Use ICI's Recommended Schedule

Funds will use the schedule to adjust the notional amount of a derivative instrument that would count towards the exposure-based and risk-based portfolio limits (subject to the increases we recommended in our March letter). Funds will use a three-step process for this adjustment:

First, a fund will determine a derivative instrument's risk adjustment under the schedule first by looking to the category of the underlying reference asset and characteristics (left-hand column of the schedule). The schedule includes categories of certain derivatives that are classified by both asset class and a broad duration grouping (*i.e.*, "Foreign Exchange/Currency," "Interest Rate," and "Credit/Debt," which, in the case of "Interest Rate" and "Credit/Debt," are further categorized into 0-1 year, 0-2 year, 1-2 year, 2-5 year, and/or 5+ year groupings). For those categories, the duration of the underlying reference asset typically determines the duration of the category. When a derivative instrument does not have a reference asset with a duration (*e.g.*, credit default swaps on single-name issuers), the fund will use the maturity of the derivative instrument itself to determine the duration of the category.

Second, the fund will multiply the derivative instrument's gross notional exposure by the fixed risk-adjustment multiplier (right-hand column of the schedule) assigned to that category. The product of a derivative instrument's gross notional exposure and its risk-adjustment multiplier would be the derivative instrument's risk-adjusted notional amount.[6]

Third, the fund will aggregate the risk-adjusted notional amounts of all the derivatives in the fund's portfolio to determine whether the fund complies with our recommended 200 percent exposure-based limit or 350 percent risk-based limit.

2. Our Rationale for Recommending the Schedule

The adjustment schedule is designed to take into account the expected riskiness of the derivative instrument's reference asset. Derivatives that typically are more risky receive a smaller adjustment (or even no adjustment) than those that are less risky. Funds, for example, would multiply the gross notional exposure for equity-based derivatives by 100 percent but multiply the gross notional exposure of 10-year interest rate derivatives by 26.7 percent.

As we expressed in our March letter, portfolio limits based on gross notional exposures are not the proper yardstick for determining whether a fund is unduly speculative. As the Commission fully recognizes, gross notional exposure could vastly overstate a fund's obligation under, and the economic

[6] As explained in the "General Notes" to the annotated schedule in Appendix A, there are some exceptions to the calculation methodology described above. The risk-adjusted notional amount for complex derivatives, for example, would equal the aggregate risk-adjusted notional amounts of derivatives, excluding other complex derivatives, reasonably estimated to offset substantially all of the market risk of the complex derivative instrument.

risks and leverage associated with, a derivatives transaction.[7] Since we submitted our letter, other regulators have voiced similar concerns with gross notional exposure. For example, in evaluating whether current methods for measuring leverage effectively assess financial stability risk, the Financial Stability Oversight Council observed that a gross notional exposure measure "does not capture differences in risk exposures across different classes of derivatives."[8] Similarly, the Chairman of the Commodity Futures Trading Commission remarked that gross notional exposure "includes derivatives, but not in a manner that accurately measures risk . . . . [and] does not take into account a variety of factors that affect risk, such as product type [or] offsetting positions. . . . ."[9]

Restricting derivatives usage based on gross notional exposures, therefore, does not meet the Commission's intent of properly distinguishing funds that are "unduly speculative" from other funds and would expose many funds to unnecessary restrictions that could inhibit a fund's ability to mitigate risks in its portfolio, achieve its investment goals and efficiencies, enhance liquidity, and lower costs in the best interest of shareholders. Our March letter discussed the results of an ICI study showing that the proposed rule's portfolio limits would have a restrictive impact on a substantial number of funds in general, and on "plain vanilla" taxable bond funds and alternative funds in particular. The proposed rule would affect these funds because the portfolio limits would count exposure, for example, to interest rate derivatives the same as exposure to more economically risky or volatile derivatives.

Our recommended schedule addresses some of the shortcomings with gross notional exposure and the adverse and unintended consequences for large numbers of funds. The schedule applies the limits in a more sensible manner that considers the economic risk and volatility of a derivative instrument and addresses concerns regarding undue speculation in a more rational and tailored fashion.[10] We continue to believe strongly that, if the Commission adopts portfolio limits restricting a fund's use of derivatives, the Commission should not base those portfolio limits on gross notional exposures but on risk-adjusted notional amounts to limit undue speculation more appropriately and

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[7] The Commission noted that a test based on gross notional amounts "could be viewed as a relatively blunt measurement in that different derivatives transactions having the same notional amount but different underlying reference assets . . . may expose a fund to very different potential investment risks and potential payment obligations." *See* proposing release at 80903.

[8] *See* Financial Stability Oversight Council, Update on Review of Asset Management Products and Activities (April 18, 2016) at 16, available at https://www.treasury.gov/initiatives/fsoc/news/Documents/FSOC%20Update%20on%20Review%20of%20Asset%20Management%20Products%20and%20Activities.pdf. The FSOC also noted that, "aggregating notional derivative amounts to measure synthetic leverage [leverage from derivatives] is likely to overstate leverage." *Id.*

[9] *See* CFTC, Statement of Chairman Timothy Massad on the Financial Stability Oversight Council's Update on its Review of Asset Management Products and Activities (April 18, 2016), available at http://www.cftc.gov/PressRoom/SpeechesTestimony/massadstatement041816.

[10] This proposed schedule is intended to be used to apply the SEC's proposed portfolio limits in a more sensible manner but is not intended to measure a fund's overall "leverage."

preserve the benefits derivatives provide to investors. We recognize, however, that the schedule will not resolve all of the concerns with the portfolio limits for funds, and certain funds may need to change substantially their investment strategies or de-register as funds registered under the Investment Company Act of 1940.[11]

We based our schedule on the prudential regulators' and CFTC's "Initial Margin Schedule" for uncleared swaps.[12] The Initial Margin Schedule already reflects industry input through the review and comment process under both the prudential regulators and CFTC proposals. That schedule also provides a realistic view of the relative risks of different asset classes and sets out appropriate risk adjustments. As described below, we made one refinement to the schedule that is consistent with the approach of the SEC's Division of Economic and Risk Analysis for short-term interest rate instruments.

Other approaches to a risk-adjustment schedule exist. We pointed out in our March letter, for example, that the SEC has adopted a "Swap Registration Schedule" that itself is risk adjusted for purposes of the security-based swap dealer registration rule.[13] That schedule serves as a SEC precedent for a risk-adjustment approach, but we believe the Initial Margin Schedule provides a better model for purposes of the current proposal.[14] First, the Initial Margin Schedule is more conservative in how it assigns the riskiness of an instrument generally (under the Swap Registration Schedule, for example, interest rate derivatives with less than one-year maturity would have a 0 percent adjustment factor). Second, the Initial Margin Schedule is used in rules that serve a similar purpose as that of the proposed derivatives rule – limiting risk. The Swap Registration Schedule, in contrast, was designed to measure a

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[11] Several funds, for example, invest in derivatives whose reference assets are based on an equity or commodity index. Those derivatives would receive no risk-adjustment to their gross notional exposure and would continue to apply their full gross notional exposure toward the portfolio limits. To the extent such a fund exceeds its portfolio limits, the fund may need to significantly change its investment portfolio to comply with the limits or de-register. In this regard, the SEC requested comment on whether funds that currently exceed the portfolio limits or that have received exemptive relief to operate leveraged or inverse ETFs should be "grandfathered" from the proposed rule's requirements. This approach may warrant further consideration and analysis, and we stand ready to assist the SEC in these efforts.

[12] *See Margin and Capital Requirements for Covered Swap Entities*, 80 Fed. Reg. 74839 (Nov. 30, 2015) (final rule) at Appendix A, available at https://www.gpo.gov/fdsys/pkg/FR-2015-11-30/pdf/2015-28671.pdf; *Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants*, 81 Fed. Reg. 636 (Jan. 2, 2016) (final rule) at Section 23.154(c), available at https://www.gpo.gov/fdsys/pkg/FR-2016-01-06/pdf/2015-32320.pdf. That schedule is reproduced in Appendix C. The Initial Margin Schedule specifies the minimum amount of initial margin that will need to be posted and received for uncleared swaps, if the parties to the swap do not elect to determine the initial margin under a model approved by the relevant regulator.

[13] *See Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and Eligible Contract Participant,"* 77 Fed. Reg. 30596 (May 23, 2012), available at https://www.gpo.gov/fdsys/pkg/FR-2012-05-23/pdf/2012-10562.pdf.

[14] We also recommended in our March letter that the SEC use the Initial Margin Schedule as a basis for expanding the types of "qualifying coverage assets" eligible for segregation under the proposal.

level of derivatives activity by a market participant that would warrant such entity being required to register with the SEC (or the CFTC).

We and our members also considered whether to recommend an entirely new schedule rather than one based on the Initial Margin Schedule. A new schedule potentially could finely tailor adjustments specifically for the purposes of proposed rule 18f-4. On balance, however, we believe that the Initial Margin Schedule is the superior model. It is based on observations of market activity regarding the relative riskiness of those instruments and incorporates significant input from market participants. Any new schedule would largely reflect the judgments inherent in the Initial Margin Schedule. Further, market participants already familiar with the Initial Margin Schedule may achieve operational efficiencies through the use of a common schedule.

We now discuss the rationale for specific elements of ICI's recommended derivatives risk-adjustment schedule.

a. Risk-Adjustment Multipliers

We determined the risk-adjustment multipliers based on the initial margin amounts required under the Initial Margin Schedule. To avoid complications, we largely retained the categories that the prudential regulators and CFTC created for various uncleared swaps.[15] The categories with the highest initial margin requirements under this schedule ("Equity," "Commodity," and "Other"), each of which has an initial margin requirement of 15 percent of gross notional exposure, were assigned a risk-adjustment multiplier of 100 percent. This categorization means that derivatives that fall into the "Equity," "Commodity," and "Other" categories would apply their full gross notional exposure towards the portfolio limits. Risk-adjustment multipliers for all other categories were determined relative to the "Equity," "Commodity," and "Other" categories by multiplying their respective gross initial margin requirement by a conversion factor of 6 2/3. The conversion factor reflects a scaling of risk to the "Equity," "Commodity," and "Other" categories and is simply the inverse of the gross initial margin (1/0.15 = 6 2/3) of these categories.[16] For example, with respect to derivatives in the category "Foreign Exchange/Currency," which pursuant to the Initial Margin Schedule require initial margin of 6 percent of the gross notional exposure of the instrument, funds would multiply the gross notional exposure of such instruments by 40 percent (*i.e.*, initial margin amount (6 percent) x conversion factor (6 2/3)) to compute their risk-adjusted notional amounts. Therefore, the proposed schedule retains the relative

[15] The categories in the prudential regulators' and CFTC's margin schedule are: Credit: 0-2 year duration; Credit: 2-5 year duration; Credit: 5+ year duration; Commodity; Equity; Foreign Exchange/Currency; Cross Currency Swaps: 0-2 year duration; Cross-Currency Swaps: 2-5 year duration; Cross-Currency Swaps: 5+ year duration; Interest Rate: 0-2 year duration; Interest Rate: 2-5 year duration; Interest Rate: 5+ year duration; and Other. *See* Appendix C.

[16] Appendix B sets out a chart showing how the risk-adjustment factor for each category was determined.

treatment of the various instruments under the Initial Margin Schedule, consistent with regulators' view of risk.

We considered a hybrid approach that would have combined the risk-adjustment multipliers derived from the Initial Margin Schedule with a duration adjustment for derivatives in the "Interest Rate" category. A duration adjustment would have scaled the risk-adjustment multipliers for interest rate derivatives based on a specified bond equivalent.[17] If the schedule used a 20-year bond equivalent, for example, an interest rate derivative instrument with a reference asset having a 20-year duration would have counted 100 percent of its gross notional exposure toward the limit and derivatives with shorter durations would have been scaled off of those amounts. We decided against this approach. The Initial Margin Schedule already includes an adjustment for duration because the initial margin requirements for interest rate derivatives with a 0-2 year duration (1 percent) are lower than the initial margin requirements for interest rate derivatives with a 2-5 year duration (2 percent) and a 5+ year duration (4 percent). Although scaling duration to a reference asset having a specific bond equivalent would have created finer distinctions among different fixed-income instruments, we concluded that the additional complexity of such an adjustment was not warranted. On balance, we were of the view that maintaining consistency with the Initial Margin Schedule on this point would ease operational burdens on funds and provide a more workable and uniform approach.

We generally retained the categories that the CFTC and prudential regulators derived for the Initial Margin Schedule, although we split "Interest Rate: 0-2 year duration" into "Interest Rate: 0-1 year duration" and "Interest Rate: 1-2 year duration." For derivatives in the "Interest Rate: 0-1 year duration" category, we propose dividing the notional amount of such derivatives by the appropriate 12-month time adjustment (*e.g.*, the notional amount of 90-day instruments would be divided by 4 because the duration of such instruments is ¼ of one year), then multiplying that amount by the risk-adjustment multiplier of 6.7 percent – the same multiplier for "Interest Rate: 1-2 year duration" derivatives. This treatment, adjusting for duration for such short-term instruments, is consistent with the treatment of short-term futures contracts in the DERA white paper that accompanied the proposing release.[18] We support this slight change to address the concern identified by DERA that the magnitude of a fund's investment exposure in short-term interest rate derivatives (*i.e.*, one year or less) is overstated, which unintentionally could impair the use of these low-risk derivatives.

b. Asset Class Categories and Classifications

We considered refining the Initial Margin Schedule even further to account for more granular distinctions in the various asset classes. We analyzed, for example, whether derivatives in the category "Credit/Debt" should be further classified into "High Yield" and "Investment Grade" to reflect the

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[17] ICI members considered using both a 10-year bond equivalent and a 20-year bond equivalent.

[18] *See* Daniel Deli, Paul Hanouna, Christof Stahel, Yue Tang & William Yost, *Use of Derivatives by Registered Investment Companies,* Division of Economic and Risk Analysis (2015), available at https://www.sec.gov/dera/staff-papers/white-papers/derivatives12-2015.pdf. *See also,* proposing release at 80908.

differing characteristics of those assets. Ultimately, we determined to recommend a more straightforward and streamlined bucketing approach for ease of use that is largely consistent with the Initial Margin Schedule. We are of the view that consistency with the Initial Margin Schedule would allow funds entering into derivatives with counterparties using the Initial Margin Schedule to classify their derivatives in the same manner as they would for determining initial margin. This would ease burdens on funds and potentially allow for a uniform classification of derivatives to develop. A less granular approach also keeps the categorizations simple, robust and unambiguous, while reducing the need for continuous updating.

ICI's recommended annotated version of the schedule lists several examples of instruments under each of the seven main asset classes to illustrate the proper categorization and to assist with the consistent application of the portfolio limits. The examples are not intended to cover all types of derivatives and are not intended to be codified into the rule. Instead, funds can use them as an effective guide for classifying many common types of derivatives.[19] Funds and their derivatives risk managers should be equipped to classify newly developed types of derivatives into the seven broad categories, including the category "Other," which pursuant to the proposed schedule would require funds to count 100 percent of their gross notional exposure toward the limit.[20]

[19] The Commission, for example, could discuss the categorization in its adopting release to provide funds guidance on how they would classify different instruments.

[20] Although the relative riskiness of various derivatives could vary over time, we believe that the conservative nature of the ICI's recommended schedule would provide the Commission with a sufficient amount of "cushion" before necessitating any change to the amounts in the schedule.

* * * * *

We appreciate the opportunity to provide further recommendations on the proposal. If you have any questions regarding ICI's recommended derivatives risk-adjustment schedule or would like any additional information, please feel free to contact me at (202) 326-5815; Dorothy Donohue, Deputy General Counsel at (202) 218-3563; Jennifer S. Choi, Associate General Counsel at (202) 326-5876; or Kenneth C. Fang, Assistant General Counsel at (202) 371-5430.

Sincerely,

/s/ David W. Blass

David W. Blass
General Counsel

cc: The Honorable Mary Jo White, Chair
The Honorable Kara M. Stein
The Honorable Michael S. Piwowar

David W. Grim, Director
Diane C. Blizzard, Associate Director
Division of Investment Management

APPENDIX A

Annotated Version of ICI's Recommended Derivatives Risk-Adjustment Schedule

Asset Class	Risk-Adjustment Multiplier	Examples of Instruments Covered
Equity	Notional x 100%	Futures on a single-name equity security, equity index, ETF, or convertible bond
		Total return swap on a single-name equity security, equity index, convertible bond, portfolio of equity securities, or portfolio of convertible bonds
		Written options on a single equity security, single name equity future, equity index, equity index future, ETF, ETF future, or convertible bond[1]
Commodity	Notional x 100%	Futures on a single commodity, commodity index, or commodity index excess return
		Commodity index options[1]
		Commodity index swaps
		Commodity index forward swaps
		Options on commodity futures[1]
Foreign Exchange/Currency	Notional x 40%	FX/currency forwards (including non-deliverable forwards)[2]
		FX/currency futures
		Currency options[1]
Cross-Currency	For cross-currency swaps and cross-currency basis swaps, the maturity of the derivative instrument determines the duration category	
	0-2 years: Notional x 6.7% 2-5 years: Notional x 13.3% 5+ years: Notional x 26.7%	Cross-currency swaps
		Cross-currency basis swaps
Interest Rate	For futures and total return swaps, the duration of the underlying reference asset determines the duration category	
	For swaptions, the maturity of the underlying swap determines the duration category	
	For interest rate swaps, caps, floors, collars, swaps on CPI, swaps on an index, and forward rate agreements, the maturity of the derivative instrument determines the duration category	

Asset Class	Risk-Adjustment Multiplier	Examples of Instruments Covered
	0-1 year: (Notional ÷ Appropriate Calendar Adjustment)[3] x 6.7%	Interest rate futures (*e.g.*, Eurodollar, Fed funds futures)
		Interest rate caps, floors and collars
	1-2 years: Notional x 6.7%	Investment grade government bond futures (*e.g.*, U.S. Treasury, UK Gilts, Euro-Bund)
	2-5 years: Notional x 13.3%	Interest rate swaps
	5+ years: Notional x 26.7%	Swaps on investment grade government bonds, investment grade government bond indexes, or investment grade government bond ETFs
		Forward rate agreements
		Swaps on CPI
		Options on interest rate futures[1]
		Swaptions[4]
Credit/Debt	For futures and total return swaps on covered instruments, the duration of the underlying reference asset determines the duration category	
	For credit default swaps and swaps on an index, the maturity of the swap determines the duration category	
	0-2 years: Notional x 13.3%	Corporate bond and non-investment grade government bond futures
	2-5 years: Notional x 33.3%	Credit spread futures
	5+ years: Notional x 66.7%	Swaps on corporate bonds and non-investment grade government bonds; corporate bond and non-investment grade government indexes; and corporate bond and non-investment grade government bond ETFs
		Credit spread swaps
		Credit default swaps on single name or index[5]
		Total return swap on a single fixed-income security or portfolio of fixed-income securities
Other	Notional x 100%	Complex derivatives (*e.g.*, volatility instruments, variance swaps, non-standard options)[6]

General Notes:

1. Funds would treat written options on these underlying asset classes on a delta-adjusted basis. For example, exposure on a written FX option will be notional x 40 percent x option delta. Purchased options are excluded.

2. We note that the Initial Margin Schedule will exclude foreign exchange swaps and forwards from any initial margin requirements. These instruments generally are not regulated as "swaps" under Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act and the Commodity Exchange Act. *See Determination of Foreign Exchange Swaps and Foreign Exchange Forwards Under the Commodity Exchange Act*, 77 Fed. Reg. 69604 (Nov. 20, 2012), available at https://www.gpo.gov/fdsys/pkg/FR-2012-11-20/pdf/2012-28319.pdf. Consistent with this approach, the Commission could choose to exclude foreign exchange swaps and forwards from counting toward any portfolio limit requirements.

3. Funds would adjust interest rate derivatives with less than a one-year maturity to a 12-month period prior to applying the risk-adjustment multiplier. For example, a fund would divide the notional amount of a 90-day instrument by four before multiplying it by the 6.7 percent risk-adjustment multiplier.

4. Funds would risk adjust swaptions based on the maturity of the underlying swap, then treat them on a delta-adjusted basis.

5. "Sold" CDS protection only. For purchased CDS protection, the sum of future premium payments would apply to the Commission's proposed portfolio limits.

6. The risk-adjusted notional amount for complex derivatives would be an amount equal to the aggregate risk-adjusted notional amounts of derivatives, excluding other complex derivatives, reasonably estimated to offset substantially all of the market risk of the complex derivative instrument.

APPENDIX B

Computation of Risk-Adjustment Multipliers

Asset Class	Gross Initial Margin (% of Notional Exposure)	Conversion Factor	Risk-Adjustment Multiplier
Credit: 0–2 year duration	2%	x 6 2/3	13.3%
Credit: 2–5 year duration	5%	x 6 2/3	33.3%
Credit: 5+ year duration	10%	x 6 2/3	66.7%
Commodity	15%	x 6 2/3	100.0%
Equity	15%	x 6 2/3	100.0%
Foreign Exchange/Currency	6%	x 6 2/3	40.0%
Cross Currency Swaps: 0–2 year duration	1%	x 6 2/3	6.7%
Cross-Currency Swaps: 2–5 year duration	2%	x 6 2/3	13.3%
Cross-Currency Swaps: 5+ year duration	4%	x 6 2/3	26.7%
Interest Rate: 0–2 year duration*	1%	x 6 2/3	6.7%
Interest Rate: 2–5 year duration	2%	x 6 2/3	13.3%
Interest Rate: 5+ year duration	4%	x 6 2/3	26.7%
Other	15%	x 6 2/3	100.0%

* Funds would adjust interest rate derivatives with less than a one-year maturity to a 12-month period prior to applying the risk-adjustment multiplier. For example, a fund would divide the notional amount of a 90-day instrument by four before multiplying it by the 6.7 percent risk-adjustment multiplier.

APPENDIX C

Standardized Minimum Initial Margin Requirements for Uncleared Swaps and Uncleared Security-Based Swaps

Asset Class	Gross Initial Margin (% of Notional Exposure)
Credit: 0–2 year duration	2%
Credit: 2–5 year duration	5%
Credit: 5+ year duration	10%
Commodity	15%
Equity	15%
Foreign Exchange/Currency	6%
Cross Currency Swaps: 0–2 year duration	1%
Cross-Currency Swaps: 2–5 year duration	2%
Cross-Currency Swaps: 5+ year duration	4%
Interest Rate: 0–2 year duration	1%
Interest Rate: 2–5 year duration	2%
Interest Rate: 5+ year duration	4%
Other	15%

Sources: *Margin and Capital Requirements for Covered Swap Entities*, 80 Fed. Reg. 74839 (Nov. 30, 2015) (final rule) at Appendix A; *Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants*, 81 Fed. Reg. 636 (Jan. 2, 2016) (final rule) at Section 23.154(c).

MEMORANDUM

To: File S7-24-15, Use of Derivatives by Registered Investment Companies and Business Development Companies

From: The Division of Economic and Risk Analysis[1]

Date: November 1, 2016

Re: Risk Adjustment and Haircut Schedules

Many commenters on proposed rule 18f-4 suggested that the rule should measure a fund's derivatives exposure using notional amounts adjusted to reflect the risks of the underlying reference assets. These commenters suggested that the Commission adopt risk-based adjustments derived from standardized schedules used for other regulatory purposes. Many commenters also suggested that a fund be permitted to maintain as qualifying coverage assets a range of assets in addition to cash and cash equivalents, subject to "haircuts" to the value of these additional assets identified in standardized schedules included in other regulatory requirements. In light of these comments, DERA staff analyzed the regulatory requirements most frequently identified by commenters.

This memorandum sets out the methods by which DERA staff performed its analysis and the results thereof. The Commission has expressed no view regarding any specific risk-based adjustments, or our analysis or its results.

1. Summary of Existing Schedules on Margin Requirements

First, we summarize the standardized schedules most frequently identified by commenters and which commenters suggested could be used to derive risk-based adjustments to notional amounts for purposes of rule 18f-4[2]: the schedules used in the final rules for margin requirements for uncleared swaps adopted by the prudential regulators and the Commodity Futures Trading Commission (PR and CFTC, respectively).[3] These schedules are consistent with the schedule

[1] This is a memo by the Staff of the Division of Economic and Risk Analysis of the U.S. Securities and Exchange Commission. The Commission has expressed no view regarding the analysis, findings or conclusions contained herein.

[2] *See, e.g.*, Comment Letter of the Investment Company Institute (July 28, 2016), *available at* https://www.sec.gov/comments/s7-24-15/s72415-244.pdf ("ICI July 28, 2016 Comment Letter") (proposing a schedule based on the PR/CFTC schedule) ; Comment Letter of the Investment Adviser Association (Aug. 18, 2016), *available at* https://www.sec.gov/comments/s7-24-15/s72415-250.pdf (while opposing portfolio limitations entirely, supporting the PR/CFTC-based schedule provided by the ICI); Comment Letter of James A. Overdahl, Delta Strategy Group (Mar. 24, 2016), *available at* https://www.sec.gov/comments/s7-24-15/s72415-85.pdf (suggesting the PR schedule as one possibility).

[3] Margin and Capital Requirements for Covered Swap Entities, 80 FR 74839 (Nov. 30, 2015), *available at* https://federalregister.gov/a/2015-28671; Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 81 FR 635 (Jan. 6, 2016), *available at* https://federalregister.gov/a/2015-32320.

for the margin requirements for non-centrally cleared derivatives published by the Bank for International Settlements (BIS), which some commenters also suggested could form a basis for adjustments to notional amounts for purposes of rule 18f-4, and so we analyze all three schedules (collectively, the "regulatory schedules") together.[4]

These sources generally provide standard margin schedules organized by reference asset class, including the asset classes most frequently discussed by commenters.[5]

Table 1. Summary of PR/CFTC/BIS Schedules

Asset Class	*Initial Margin Requirement*[a]
Credit: 0–2y duration	2%
Credit: 2–5y duration	5%
Credit 5+y duration	10%
Commodity	15%
Equity	15%
Foreign exchange	6%
Interest rate: 0–2y duration	1%
Interest rate: 2–5y duration	2%
Interest rate: 5+y duration	4%

[a] Expressed as % of notional exposure

As depicted in Table 1, the initial margin schedules set by the PR, CFTC, and BIS are identical for all reference asset classes analyzed.

[4] Basel Committee on Banking Supervision, Board of the International Organization of Securities Commissions (Mar. 2015), *available at* http://www.bis.org/publ/bcbs261.pdf; *see, e.g.*, Comment Letter of the Securities Industry and Financial Market Association (Mar. 28, 2016), *available at* https://www.sec.gov/comments/s7-24-15/s72415-174.pdf (primarily supporting BIS schedule).

[5] We do not analyze specific types of derivatives transactions, and thus do not analyze cross currency swaps, which are included in the PR/CFTC schedules but are not included in the BIS schedule.

2. Risk Analyses and Comparisons

To evaluate commenters' suggestions regarding these standardized schedules, we assess how they relate to the risks of the underlying reference assets. We use the PR and CFTC schedules, and the BIS schedule, as the main reference point because they were most frequently identified by commenters and provide identical values for all of the asset classes analyzed below.[6]

2.1. U.S. Treasury Securities

Commenters suggested two different means of risk-adjusting the notional values for interest rate derivatives. These are discussed below.

2.1.1. Risk Comparisons of the Existing Schedules

Because the regulatory schedules provide that the highest amount of initial margin applies to equity derivatives, the volatility of large capitalization equity securities can be used as a baseline against which to compare the other asset classes in the schedule.[7] To evaluate the suggested risk adjustments for interest rate ("IR") derivatives, we first determine the relative risk of U.S. Treasury securities as compared to domestic large capitalization equity securities. We compute risk levels (*i.e.*, monthly standard deviations) using monthly total returns of the S&P 500 and the Barclays Treasury Series from January 1997 to July 2016, for which we have data available.[8] We then divide the standard deviation of the U.S. Treasury securities by the standard deviation of the S&P 500 to compute the risk ratios. Table 2 summarizes the results.

[6] The risk analyses performed here are based on indexes rather than individual securities. We believe that the analyses should generally capture the relative risk across various asset classes.

[7] The initial margin requirements in the regulatory schedules are expressed as a percentage of notional amounts, which are subject to additional calculations to determine initial margin amounts to be collected under the applicable regulatory margin requirements. The regulatory schedules provide that the highest amount of initial margin also must be collected for commodity derivatives. A comparison of S&P 500 and two commonly used commodity indexes (the Bloomberg and the S&P GSCI commodity indexes) indicates that commodities have a similar or somewhat higher risk level as compared to equity securities.

[8] To understand whether the risk ratios we calculated would be materially different under different sets of market conditions, including during periods of financial stress, we perform these analyses using data from 2008-2010. We obtain similar findings, which are provided in the appendix. Data for the S&P 500 are obtained from Morningstar. Data for all Treasury and corporate bond series are obtained from Datastream.

Table 2. Risk Analyses for U.S. Treasury vs Equity Securities

	(1)	*(2)*	*(3)*	*(4)*
Asset Class	*Risk Level (standard deviation of historical returns)*	*Initial Margin Requirement under PR/ CFTC/BIS schedules*	*Risk Ratio implied by PR/CFTC/BIS schedules*[a]	*Risk Ratio computed relative to Equity risk level*
Equity	4.45	15%	100%	100%
Treasury IR: 0–2y	0.27[b]	1%	7%	6%
Treasury IR: 2–5y	0.62[c]	2%	13%	14%
Treasury IR: 5+y	2.48[d]	4%	27%	56%

[a] Computed as the initial margin requirement of an asset class divided by the initial margin requirement of equity (15%)
[b] Computed using interest rate of Treasury 0-3 months and 1-2 years
[c] Computed using interest rate of Treasury 1-5 years
[d] Computed using interest rate of Treasury 5-10, 10-20, and 20+ years

Historical risk levels and risk ratios implied by the PR, CFTC, and BIS schedules for equity (S&P 500 as proxy) and various Treasury securities are reported in Columns 1 and 2 of Table 2. The implied risk ratio from the existing regulatory schedules (initial margin of an asset class divided by initial margin requirement for equity) is reported in Column 3. Commenters suggested that these implied risk ratios can be used as the multipliers to calculate risk-adjusted notional amounts for purposes of rule 18f-4.[9] Column 4 reports realized risk ratios calculated by the ratio between the historical volatility of the Treasury series and the historical volatility of the S&P 500.

Comparing columns 3 and 4, we observe that for short-term Treasury securities (2 years or less), the margin schedules are roughly consistent with the underlying risk levels of the reference assets. We compute a risk ratio of 6%, as compared to the 7% implied from the PR, CFTC, and BIS schedules.

For medium-term U.S. Treasury securities, the ratios are also consistent, although due to data availability our series is for 1 to 5 years, rather than 2 to 5 years as in the regulatory schedules.[10,11]

[9] *See supra* footnotes 2 & 4.

[10] Please also note that BIS and CFTC schedules classify interest rate derivatives using duration rather than maturity. For most U.S. Treasury securities (up to 10 years), durations are fairly close to actual maturities (*e.g.*, for 1 year U.S. Treasury securities, duration is 0.96; for 5 year U.S. Treasury securities, duration is 4.85). Therefore, using maturity as a substitute for duration in this analysis will have a minimal impact on our comparisons using maturity-based series.

For long-term U.S. Treasury securities with maturities exceeding 5 years, our analyses indicate a higher calculated risk ratio (56%) versus what is implied by the PR, CFTC, and BIS schedules (27%). We note, however, that if long-term U.S. Treasury securities refer to those with mainly 5 to 10 year maturities, our risk analyses yield a risk ratio of 36%, which is closer to these schedules.

2.1.2. Reference Bond

Commenters suggested in the alternative that rule 18f-4 should permit funds to adjust the amount of interest rate derivatives by normalizing them to a specified reference bond. Some commenters suggested that the 10-year Treasury bond would be an appropriate reference bond, whereas others suggested the appropriate reference bond would be the 30-year Treasury bond because these commenters asserted that the 30-year Treasury bond has a level of volatility roughly comparable to that of equity markets.[12]

Using data from 1980 to 2016, we compute the risk levels of these asset classes and find that this methodology suggests that the relative risk level for the 30-year Treasury bond is 86% of the S&P 500, while the relative risk level for the 10-year Treasury bond is 55%.

Table 3. 10-year vs 30-year Treasury Bond Risk

	S&P500	*30-year Treasury*	*10-year Treasury*
Risk (std. dev.)	4.35	3.74	2.38
Risk Ratio	1	0.86	0.55

2.2. Credit Derivatives

Credit derivatives can be exposed to either both default risk and interest rate risk or to predominantly default risk. We first evaluate commenters' suggested adjustments for credit derivatives based on regulatory schedules by analyzing how the risk of corporate debt compares to the risk of equity. Then, we investigate credit derivatives that predominantly are exposed to default risk by comparing the risk of credit default swaps ("CDS") relative to the risk of equity.

[11] For the consistency of the analyses, we used U.S. Treasury series from Barclays obtained from Datastream. This data source is only available in a 1 to 5 year series, and a 2 to 5 year series cannot be separately derived from it.

[12] *See, e.g.* Comment Letter of Guggenheim Investments, *available at* https://www.sec.gov/comments/s7-24-15/s72415-163.pdf; Comment Letter of Pacific Investment Management Company LLC, *available at* https://www.sec.gov/comments/s7-24-15/s72415-168.pdf ("PIMCO Comment Letter"); Comment Letter of Capital Research and Management Company, *available at* https://www.sec.gov/comments/s7-24-15/s72415-153.pdf.

2.2.1. Corporate Debt

Table 4 reports risk levels using total returns of the S&P 500 and the indexes of the AAA- and BBB- rated bonds from 2004 to 2016, the period for which we have data available.

Table 4. Risk Analyses for Corporate Debt vs Equity

	(1)	*(2)*	*(3)*	*(4)*
Asset Class	*Risk Level (standard deviation of historical returns)*	*Initial Margin Requirement under PR/CFTC/BIS schedules*	*Risk Ratio implied by PR/CFTC/BIS schedules*	*Risk Ratio computed relative to Equity risk level*
Equity	4.09	15%	100%	100%
Credit: 0–2y duration	0.70[a]	2%	13%	17%
Credit: 2–5y duration	1.33[b]	5%	33%	33%
Credit 5+y duration	2.46[c]	10%	67%	60%

[a] Computed using AAA and BBB 1-3 years
[b] Computed using AAA and BBB 3-5 years and 5-7 years
[c] Computed using AAA and BBB 7-10, 10-15 and 15+ years

The implied risk ratios are, again, computed as the initial margin requirement for an asset class divided by the initial margin requirement for equity. Comparing columns 3 and 4, we observe that the implied risk adjustment ratios and the ratios we computed from the risk analyses are generally consistent for all three maturity categories.[13] For the short-term credit category, our analyses indicate that the PR, CFTC, and BIS schedules have an implied risk ratio that is slightly lower than the risk ratio computed, while for the long-term category, the risk ratio implied from the schedules is slightly higher. To evaluate a comment regarding adjusting risk on a continuum rather than by bucketing instruments together,[14] we note that dividing duration by 10 times 100% results in a continuum of risk ratios that is generally consistent with the risk adjustments in the regulatory schedules.[15]

[13] The maturities used in our risk analyses are slightly higher in order to provide for a comparable comparison between the values included in the regulatory schedules, which are determined on the basis of duration, and the values used in our analyses, which are based on the relevant securities' maturities.

[14] PIMCO Comment Letter (noting that a duration adjustment to a specified reference bond adjusts risk on a continuum rather than bucketing instruments with different risk characteristics together).

[15] For durations between 0.25 years and 2 years, between 2 years and 5 years, and between 5 years and 10 years, the adjusted risk ratios are between 2.5% and 20%, between 20% and 50%, and between 50% and 100%, respectively.

2.2.2. Credit Default Swaps

To evaluate the risk of CDS we compute standard deviations of CDS returns.[16] Table 5 reports the risk levels of returns of the CDX CDS index obtained from Capital IQ Inc. and those of total returns of the S&P 500 index. The data cover the period from 2008 to 2014, for which the CDS data is available.[17]

The table shows that returns for CDS contracts referencing high yield corporate debt are more volatile than those for CDS referencing investment grade corporate debt.[18] The CDS contracts that exhibit the highest risk level are those for high yield CDS with a tenor of 10 years. [19] The returns to these CDS have a standard deviation of 1.16 % per month and their risk ratio relative to equities is 24%.

Table 5. Risk Analyses for CDS vs Equity

		(1)	*(2)*
Asset Class		*Risk Level (standard deviation of historical returns)*	*Risk Ratio computed relative to Equity risk level*
Equity (S&P 500)		4.86	100%
CDS, investment grade	1y tenor	0.02	0%
	5y tenor	0.18	4%
	10y tenor	0.31	6%
CDS, high yield	1y tenor	0.29	6%
	5y tenor	0.84	17%
	10y tenor	1.16	24%

[16] Standard deviations are computed from daily data and scaled to monthly frequency using the square root of the average number of daily observations per month during the sample.

[17] CDS returns are computed as -Δ(CDS Spread)×PV01, where PV01 is the change in the value of the CDS contract, relative to the notional amount of the CDS, for a one percentage point increase in the CDS spread.

[18] In this table, we are not reproducing the initial margin requirements under the PR/CFTC/BIS schedules and the risk ratios implied by PR/CFTC/BIS schedules because the schedules do not distinguish between investment grade and high-yield corporate debt.

[19] In recommending how funds would use the PR/CFTC schedule, one commenter distinguished the way that funds should calculate the risk adjustment for credit default swaps from the calculation for other credit derivatives, suggesting that for credit default swaps, funds use the maturity or tenor of the swap, while for other derivative instruments, funds use the duration of the underlying reference asset. *See* ICI July 28, 2016 Comment Letter.

2.3. Currency

To understand the risk of currency, we estimate currency risk using the Nominal Broad Dollar Index, obtained from the Federal Reserve Board website.[20] The broad index is a weighted average of the foreign exchange values of the U.S. dollar against the currencies of a large group of major U.S. trading partners.[21]

We compare the risk of currency to the risk of the S&P 500 index from 1973 to July 2016, the period for which we have data for both data series. We follow the same approach discussed above by dividing the standard deviation of this currency basket by the standard deviation of the S&P 500. The comparison yields a risk adjustment multiplier of 29%, as compared to the 40% multiplier implied by the PR, CFTC, and BIS schedules. The schedules are broadly consistent with our analysis, which is based on a broad currency index that is highly diversified. This analysis, however, does not address whether narrower groupings of currencies or particular currencies would yield different risk adjustment multipliers.

3. Haircut Schedule

In addition to risk-based notional amount adjustments, commenters also suggested that the final rule permit funds to maintain high quality and liquid assets in addition to cash and cash equivalents as qualifying coverage assets.[22] Many commenters also suggested that the haircuts applicable to these assets be determined pursuant to the schedule of assets that may be used to satisfy the PR and CFTC margin requirements for uncleared swaps.[23] In light of these comments, we summarize assets that may be used to satisfy these margin requirements and analyze these assets and their corresponding haircuts in light of historical risk levels across certain asset classes.

[20] The data is available from Federal Reserve Board website at http://www.federalreserve.gov/datadownload/Choose.aspx?rel=h10.

[21] For details on the construction of the index, see the article in the Winter 2005 Federal Reserve Bulletin, available at http://www.federalreserve.gov/pubs/bulletin/2005/winter05_index.pdf.

[22] *See* SIFMA Letter, *supra* note 2, at 29.

[23] *See id.*; *see also* ICI July 28, 2016 Comment Letter; Comment Letter of the US Chamber of Commerce (Mar. 28, 2016), *available at* https://www.sec.gov/comments/s7-24-15/s72415-148.pdf; Comment Letter of Vanguard (Mar. 28, 2016), *available at* https://www.sec.gov/comments/s7-24-15/s72415-162.pdf.

Table 6. Margin Values for Eligible Noncash Margin Collateral from PR/CFTC Schedules

Asset Class	*Discount %*
Eligible government and related (e.g., central bank, multilateral development bank, GSE securities identified in §23.156(a)(1)(iv)) debt[1]: residual maturity less than one-year.	0.5
Eligible government and related (e.g., central bank, multilateral development bank, GSE securities identified in §23.156(a)(1)(iv)) debt[1]: residual maturity between one and five-years	2.0
Eligible government and related (e.g., central bank, multilateral development bank, GSE securities identified in §23.156(a)(1)(iv)) debt[1]: residual maturity greater than five-years	4.0
Other eligible publicly traded debt[2,3]: residual maturity less than one year	1.0
Other eligible publicly traded debt[2,3]: residual maturity between one and five years	4.0
Other eligible publicly traded debt[2,3]: residual maturity greater than five years	8.0
Equities included in S&P 500 or related index	15.0
Equities included in S&P 1500 Composite or related index but not S&P 500 or related index[24]	25.0

[1] This category includes any security that is issued by, or fully guaranteed as to the payment of principal and interest by, the European Central Bank or a sovereign entity that is assigned no higher than a 20 percent risk weight under the capital rules applicable to the covered swap entity, or an OECD Country Risk Classification rating of 0-2.

[2] This category includes corporate and municipal debt securities that are investment grade, as defined by the prudential regulators.

[3] Note that GSE debt securities not identified in §23.156(a)(1)(iv) receive the same discounts as Other eligible publicly traded debt.

First, to understand how the schedule of assets that may be used to satisfy the PR and CFTC margin requirements for uncleared swaps relates to the underlying risk of certain margin-eligible assets, Table 7 reports haircut discounts computed based on historical risk levels of various asset classes and compares them to the schedules. The risk ratios reported in the table are calculated by dividing the standard deviation of the given reference asset by the standard deviation calculated for the S&P 500. The haircut discounts are then computed by multiplying that risk ratio by the haircut (15%) set for the S&P 500.[25]

[24] We did not analyze the risk associated with the S&P 1500 due to data limitations.

[25] Our review of Table 6 does not seek to analyze the entire PR/CFTC schedule, but rather to examine common categories of assets (U.S. Treasury securities, corporate debt, and equity).

Table 7. Haircut Schedule Based on Risk

		(1)	*(2)*	*(3)*	*(4)*	*(5)*
Asset Class		*Risk Level (standard deviation of historical returns)*	*Haircut/ Discount under PR/CFTC schedules*	*Risk Ratio implied by PR/CFTC schedules*	*Risk Ratio computed relative to Equity risk level*	*Haircut/ Discount Computed*[e]
Treasury[a,b]	<1yr	0.18	0.5	3%	4%	0.6
	1-5yr	0.62	2	13%	14%	2.1
	>5yr	2.48	4	27%	56%	8.4
Corporate[c,d]	<1yr	—[g]	1	7%	—[g]	—[g]
	1-5yr	0.90	4	27%	22%	3.3
	>5yr	2.24	8	53%	55%	8.3
Equity (S&P 500)		4.45[f] (4.09)	15	100%		

[a] The securities in the regulatory schedule are defined as eligible "government and related"
[b] The risk is computed using U.S. Treasury series from 1997 to 2016
[c] The securities in the regulatory schedule are defined to include certain eligible "publicly traded debt"
[d] The risk is computed using AAA and BBB corporate bond series from 2004 to 2016. The risk of corporate 1-5 year series is computed using 1-3 and 3-5 year corporate series
[e] Haircut Discount Computed = Risk Ratio Computed × Equity Haircut = Risk Ratio Computed × 15
[f] The risk levels of equity (S&P 500) are 4.45% from 1997 to 2016 and 4.09% from 2004 to 2016
[g] Due to data limitations, we do not analyze risk of corporate debt with maturity of less than 1 year

Comparing the existing discounts, or haircuts, reported in column 2 and the discounts based on risk levels reported in the last column, we observe that the existing haircut schedule generally is consistent with the underlying risk levels of the reference assets. The risk level of the long-term U.S. Treasury securities, however, based on historical risk levels, is higher than the risk level implied in the existing haircut schedule (i.e., 56% vs 27% as compared to equity). We note, however, that if we focus on the 5–10 year U.S. Treasury series, our risk analyses indicate a 35% risk ratio and a 5.3 haircut/discount, which are roughly consistent with the existing schedule.[26]

[26] Note also that corporate debt securities included in this analysis only consist of AAA and BBB bonds; high-yield categories are not included so as to facilitate the comparison with the existing schedule. Therefore, the risk differences between corporate and Treasury securities appear small, especially for the long-term maturity series. But our analyses show that high-yield bonds are more than twice as risky as comparable Treasury securities.

In addition, the 15% discount for domestic large capitalization equities is used in our analyses as a benchmark to compare risk levels and set the schedule. To understand whether this discount level is consistent with the observed volatility of large capitalization domestic equities, we further perform VaR tests on the S&P 500. These allow us to understand how much equity value can be expected to be lost under extreme conditions. Using monthly data from the past four decades, we observe that 1% of the time, the S&P 500 index can be expected to lose more than 11% in value over a month (*i.e.*, approximately 20 trading days). The haircut schedule included in the PR and CFTC rules for uncleared swaps is generally consistent with this analysis, in that it provides for a 15% haircut for large cap equity securities and provides a greater haircut of 25% for other equity securities that generally would be expected to experience greater volatility.

4. Risk Analyses for Crisis Periods

To further understand whether the values in the regulatory schedules are consistent during crisis periods when market volatility increases, we perform the above risk analyses using data from 2008 to 2010. Overall, the risk ratios among various asset classes stay roughly consistent with those found in the overall sample. The detailed results are attached in the appendix.

Appendix: Risk Analyses during 2008-2010

A.1. Risk Analyses for U.S. Treasury Securities vs Equity

	(1)	*(2)*	*(3)*	*(4)*
Asset Class	*Risk Level (standard deviation of historical returns)*	*Initial Margin Requirement under PR/ CFTC/BIS schedules*	*Risk Ratio implied by PR/CFTC/BIS schedules*[a]	*Risk Ratio computed relative to Equity risk level*
Equity	6.40	15%	100%	100%
Treasury IR: 0–2y	0.25[b]	1%	7%	4%
Treasury IR: 2–5y	0.80[c]	2%	13%	12%
Treasury IR: 5+y	3.62[d]	4%	27%	57%

[a] This is computed as initial margin requirement divided by the initial margin requirement of equity (15%).
[b] Computed using interest rate of Treasury 0-3 months, 1-2 years
[c] Computed using interest rate of Treasury 1-5 years
[d] Computed using interest rate of Treasury 5-10, 10-20, and 20+ years

A.2. Risk Analyses for Corporate Debt vs Equity

	(1)	*(2)*	*(3)*	*(4)*
Asset Class	*Risk Level (standard deviation of historical returns)*	*Initial Margin Requirement under PR/CFTC/BIS schedules*	*Risk Ratio implied by PR/CFTC/BIS schedules*	*Risk Ratio computed relative to Equity risk level*
Equity	6.40	15%	100%	100%
Credit: 0–2y duration	1.27[a]	2%	13%	20%
Credit: 2–5y duration	2.25[b]	5%	33%	35%
Credit 5+y duration	3.91[c]	10%	67%	61%

[a] Computed using AAA and BBB 1-3 years
[b] Computed using AAA and BBB 3-5 years and 5-7 years
[c] Computed using AAA and BBB 7-10, 10-15 and 15+ years

A.3. Haircut Schedule Based on Risk

		(1)	(2)	(3)	(4)	(5)
Asset Class		*Risk Level (standard deviation of historical returns)*	*Haircut/ Discount under PR/CFTC schedules*	*Risk Ratio implied by PR/CFTC schedules*	*Risk Ratio computed relative to Equity risk level*	*Haircut/ Discount Computed*[b]
Treasury[a,b]	<1yr	0.08	0.5	3%	1%	0.2
	1-5yr	0.80	2	13%	12%	1.9
	>5yr	3.62	4	27%	57%	8.5
Corporate[a]	<1yr	—	1	7%	—	—
	1-5yr[c]	1.56	4	27%	24%	3.7
	>5yr	3.59	8	53%	56%	8.4
Equity (S&P 500)		6.40	15	100%		

[a] Computed using AAA and BBB series
[b] Haircut Discount Computed = Risk Ratio Computed × Equity Haircut = Risk Ratio Computed × 15
[c] Computed using 1-3 and 3-5 year corporate series

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Manitoba Securities Commission
Ontario Securities Commission
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SENT VIA EMAIL

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

Morgan Meighen & Associates Limited ("MMA" or "we"), appreciates the opportunity to submit comments with respect to the Notice.

By way of background, MMA is registered as portfolio manager and exempt market dealer in the provinces of Ontario, Alberta, British Columbia and Manitoba. We are also registered as an

investment fund manager in the province of Ontario. MMA has approximately $1.6 billion in assets under management. We have a broad base of clients, including individual and institutional private clients, as well as pooled funds, for which we carry out activities under our portfolio manager, exempt market dealer and investment fund manager registrations, as applicable.

Of particular relevance to the Notice is the fact that MMA manages two TSX-listed closed-end investment funds, considered non-redeemable investment funds under securities regulations. These funds are "traditional" closed-end funds, which do not offer redemption privileges, at any time, to shareholders, or have a future "wind-up" date. One of these funds, Canadian General Investments, Limited ("CGI"), which has been in existence for over eighty years, also carries a listing on the London Stock Exchange. CGI has engaged in a leveraging strategy since 1998 in an effort to enhance returns to common shareholders, primarily through the issuance of series of TSX-listed preferred shares but, since 2013, also through a credit facility. The other fund, Canadian World Fund Limited, also maintains a credit facility, but has not drawn down on the facility for several years.

We would like to acknowledge that we are supportive of the efforts to harmonize regulations pertaining to operational requirements and investment restrictions for all investment funds, including alternative funds and non-redeemable investment funds, under National Instrument 81-102 *Investment Funds*.

Illiquid Assets:

In Annex A, you are soliciting feedback concerning whether the proposed limits on the amount of illiquid assets held by a non-redeemable investment fund (20% of NAV at the time of purchase, with a hard cap of 25% of NAV) are appropriate for most non-redeemable investment funds, as well as 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 had provided our views in this area in our August 23, 2013 comment letter regarding Staff Notice and Request for Comment re: Proposed Amendments to National Instrument 81-102 *Mutual Funds*, Companion Policy 81-102CP *Mutual Funds* and Related Consequential Amendments and Other Matters Concerning National Instrument 81-104 *Commodity Pools* and Securities Lending, Repurchases and Reverse Repurchases by Investment Funds. We repeat those comments below as our position on this has not changed:

> *"Investments in Illiquid Assets*
>
> Historically, the ability to invest in less liquid investments has been one of the primary benefits of the closed-end fund structure over that of a mutual fund. Illiquid investments, whether unlisted or thinly traded, can be undervalued by the market as a result of their illiquid nature, providing an opportunity for the fund to earn a higher return, particularly over the longer term. Specific examples would be a private company eventually going public, a closely-held company buying in shares held by outside shareholders, or similar special situation.
>
> Liquidity needs of closed-end fund shareholders, each of whom has different

requirements or expectations, are handled directly by the shareholders themselves, selling or buying their shares of the fund through a broker or dealer. With infrequent redemptions to worry about, or in our case where there are no redemptions, cash flows are limited primarily to dividend payments, management fees, operating expenses, and tax instalments, which are relatively easy to forecast.

As every investment fund is unique, in our view, with respect to illiquid investments no single specific limit (or limits – one for redeemable funds and one for non-redeemable funds) should be mandated. Whether a fund is redeemable or non-redeemable, the manager of the fund, acting under the oversight of the fund's board of directors or trustees, is in the best position to evaluate a fund's own liquidity needs and, in the normal course of conducting prudent portfolio management practices, determine the appropriate level of illiquid assets that may be held. This determination will be driven by such factors as the frequency of redemptions, other cash flow needs, investment mandate, market conditions, outlook for different asset classes and so on. Shareholders and other interested parties are already provided information enabling them to evaluate a fund's liquidity risk and what is being done to manage that risk by reading through the notes to a fund's financial statements as this is required disclosure under current accounting guidelines."

It is our continued belief that no single limit can be established that should apply to all non-redeemable investment funds. In particular, since the concerns expressed in the Notice all seem to be tied into an investment fund's ability to fund redemptions, where a non-redeemable investment fund does not allow securities to be redeemed, there doesn't seem to be a potential concern that needs to be addressed in the first place and therefore no reason to establish a limit.

Borrowing:

We wanted to seek clarification on the wording in the text of the proposed amendments related to borrowing contained in proposed section 2.6 Investment Practices. Specifically, 2.6(1) states:

"(1) An investment fund must not,

(a) borrow cash or provide a security interest over any of its portfolio assets unless
(i) the transaction……"

Subsequently, the proposed amendments incorporate draft wording for 2.6(2), specifically intended for alternative funds and non-redeemable investment funds, as follows:

"(2) An alternative fund or a non-redeemable investment fund may borrow cash in excess of the limits set out in subsection (1) provided that each of the following applies:

(a) the alternative fund or non-redeemable investment fund …..
(b) if the lender …….
(c) the borrowing agreement entered into is in accordance with normal industry practice and on standard commercial terms for the type of transaction; and
(d) the total value ….."

MORGAN MEIGHEN & ASSOCIATES
Investment Management

Although 2.6(2) permits alternative funds and non-redeemable investment funds to borrow cash outside of the parameters of 2.6(1), it is silent on the ability of an alternative fund or a non-redeemable investment fund to provide a security interest over its portfolio assets. For longer-term borrowing arrangements, it is common practice for alternative funds and non-redeemable investment funds to provide a security interest over portfolio assets by entering into a general security agreement with the lender. While this may have been implied by the inclusion of draft 2.6(2)(c) above, since it refers to "normal industry practice and on standard commercial terms", we ask that consideration be given to clarifying the wording of this subsection further. For example;

" (c) the borrowing agreement entered into is accordance with normal industry practice and on standard commercial terms, including the granting of a security interest over the investment fund's portfolio assets, for the type of transaction."

If you should have any questions, or require further information, please do not hesitate to contact me.

Yours truly,

Frank Fuernkranz
Vice-President Finance & Secretary

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PICTON MAHONEY
Asset Management

December 22, 2016

DELIVERED 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 Consumer Services Commission of 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

Delivered to:

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

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
Fax : 514-864-6381
E-mail: consultation-en-cours@lautorite.qc.ca

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.

PICTON MAHONEY
Asset Management

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

Delivered by Email

December 22, 2016

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

Attention:

The Secretary
Ontario Securities Commission
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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 and Mesdames:

RE: CSA Notice and Request for Comment—Modernization of Investment Fund Product Regulation—Alternative Funds

We are writing in response to the CSA Notice and Request for Comment published on September 22, 2016 (the "**Notice**") concerning proposed amendments (the "**Proposed Amendments**") that include a comprehensive framework for the regulation of "alternative funds" (the "**Alternative Funds Proposal**") under National Instrument 81-102 Investment Funds ("**NI 81-102**").

We are writing following consultation with a number of participants in the non-redeemable investment fund ("**NRIF**") industry. These comments do not necessarily represent the views of the members of our respective firms or our clients.

Our comments below are divided into two Parts. In Part I we address certain of the specific questions of the CSA relating to the Proposed Amendments, including certain proposed investment restrictions for NRIFs that the CSA considered to be interrelated with the Alternative Funds Proposal regarding investments in physical commodities, borrowing cash, short selling and use of derivatives defined as the "**Interrelated Investment Restrictions**".

In Part II we provide some additional comments on the Proposed Amendments and NI 81-102, generally.

Part I **Specific CSA Questions**

Question 1—Definition of "Alternative Fund"

We support the use of the term "alternative fund", but it is not apparent to us why the CSA felt the need to define an alternative fund as a type of mutual fund or to integrate alternative funds into NI 81-102. After nearly three years of development, this feels like an opportunity missed to develop a truly alternative funds framework.

Question 3—Concentration

We do not believe that an upper limit or hard cap on concentration is required for an alternative fund or a NRIF as we believe that concentration and liquidity are separate issues. See our comments on liquidity in the following response. We submit that some investors may find concentrated positions more appealing in an alternative fund or a NRIF, as they often focus on diversification across their portfolio rather than within products they hold in their portfolio.

Questions 5 & 7—Illiquid Assets/Redemptions

We reiterate our view that restrictions on concentration and illiquid assets are not required for alternative funds and NRIFs that are not redeemable, infrequently redeemable or exchange listed such that investors do not rely solely on redemption rights for liquidity. The linkage between a fund's liquidity requirements and the right to redeem units/shares is widely recognized. For example, in its 2013 report *Principles of Liquidity Risk Management for Collective Investment Schemes*, IOSCO recommended 15 principles including that "The responsible entity should set appropriate liquidity thresholds which are proportionate to the redemption obligations and liabilities of the [collective investment scheme]". The report states, "For example, a daily dealing CIS would be expected to have stricter liquidity requirements than a CIS sold on the basis that investors would not be expected to redeem before a set period expired."

It follows that a fund with less frequent redemptions would be expected to have less strict liquidity requirements.

Imposing liquidity requirements on funds that do not match a fund's terms and conditions and investor expectations, we submit, may impose unwarranted costs on investors including restrictions that limit innovation and differentiation. We also do not believe that securities regulators should seek to impose portfolio restrictions for other reasons such as "safety" or capital preservation which is better left to portfolio managers to assess and manage in the context of other products in the market.

Question 6—Illiquid Assets/Investment Cap

We do not believe that a cap on illiquid assets is required for alternative funds and NRIFs. Some investors may want access to less liquid assets classes potentially offered by alternative funds or NRIFs and the Proposed Amendments would limit such access.

Question 8—Borrowing

We do not agree with the proposal to restrict alternative funds and NRIFs to borrowing from entities that would qualify as an investment fund custodian under section 6.2 of NI 81-102, which essentially restricts borrowing to banks and trust companies in Canada (or their dealer affiliates). Since an alternative fund or a NRIF is not exposed to the credit risk of a lender, we do not see the policy rationale for excluding lending to investment funds by (i) foreign lenders and (ii) Canadian lenders that are not financial institutions. In our view, this restriction unnecessarily limits market options and may contribute to higher borrowing costs being borne by investors.

We agree with the proposals for independent review committee approval where the lender is an affiliate of the investment fund's investment fund manager and that loan agreements should be in accordance

with normal industry practice and on standard commercial terms. We submit that these proposals, together with existing restrictions on lending under Section 13.12 of NI 31-103, are sufficient counterparty restrictions.

At a minimum, to facilitate lending by foreign lenders, we submit that alternative funds and NRIFs should be permitted to borrow from entities described in Section 6.3 as well as Section 6.2 of NI 81-102.

Finally, for consistency, the requirement in Section 6.2(3)(a) that financial statements must "have been made public" should be removed. This requirement (i) does not apply to an entity under Section 6.3 of NI 81-102 and (ii) has been removed from the definition of "Canadian custodian" under proposed amendments to National Instrument 31-103 *Registration Requirements, Exemptions and Ongoing Registrant Obligations*, published for comment on July 7, 2016. This approach would codify exemptive relief granted to bank-owned affiliates from the public disclosure requirement under Section 6.2(3)(a) of NI 81-102 in the past.

Questions 9, 10 & 11—Total Leverage Limit

We do not agree with using the gross notional amount of specified derivatives as a portfolio leverage limit in a manner that does not take into account the actual amount of market risk exposure in any individual position or the amount of risk exposure of the portfolio. As you are no doubt aware, the SEC adopted this "blunt instrument" approach in proposed rule 18f-4 under the *Investment Company Act of 1940*, as amended, regarding the use of derivatives and certain related instruments by registered investment companies (the "**SEC Proposal**").[1]

Proposed rule 18f-4 limits the amount of leverage a fund may obtain through derivatives or certain other senior securities transactions, by requiring that a fund comply with a new requirement to limit a fund's aggregate exposure using one of two alternatives. The first alternative imposes a gross notional exposure limit of 150 percent of a fund's net assets. The second alternative imposes a risk-based gross notional limit of 300 percent of a fund's net assets for those funds where the derivatives transactions, in aggregate, result in an investment portfolio that is subject to less market risk than if the fund did not use such derivatives.[2]

We believe that any leverage definition for specified derivative exposure should include netting of risk-mitigating instruments. We agree that the CSA should allow a fund to include offsetting or hedging transactions to reduce its calculated leveraged exposure.

Netting is permitted under both proposed rule 18f-4 and in guidelines of the Committee of European Securities Regulators for funds subject to the European Union's Undertakings for Collective Investment in Transferable Securities ("**UCITS**") directive. However, we submit, both of these approaches are unduly complex and overly restrictive.

These approaches and alternatives have been exhaustively canvassed in the SEC Proposal and the more than 175 comment letters and papers that the SEC received in response to the SEC Proposal.[3] We refer you to two in particular:

(i) White Paper by James A. Overdahl, Ph.D. Delta Strategy Group, *Proposed Rule 18f-4 on the Use of Derivative Instruments by Registered Investment Companies* dated March 24, 2016;[4] and

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[1] See "Use of Derivatives by Registered Investment Companies and Business Development Companies," Release
No. IC-31933 (Dec. 11, 2015), available at: http://www.sec.gov/rules/proposed/2015/ic-31933.pdf.

[2] White Paper by James A. Overdahl, Ph.D. Delta Strategy Group, Proposed Rule 18f-4 on the Use of Derivative Instruments by Registered Investment Companies dated March 24, 2016 at page 7.

[3] *The Investment Lawyer*, Vol. 23, No. 6, June 2016. Available at:
https://www.dechert.com/files/Uploads/Documents/FSG/IL_0616_Hinkle_Kerfoot_Dreyfuss.pdf

(ii) Letter from Timothy W. Cameron, Esq., Asset Management Group–Head, Securities Industry and Financial Markets Association, to Brent J. Fields, Secretary, Securities and Exchange Commission, dated March 28, 2016.[5]

Rather than being overly prescriptive, we encourage the OSC to continue the principles based approach in NI 81-102 and exclude from the exposure limit calculation any exposure associated with derivatives transactions that may be used to hedge or cover other transactions. Many transactions such as currency hedging and offsetting positions under equity swaps are easily identified and widely accepted as transactions that do not increase portfolio leverage but rather reduce market risk.

Question 12—*Interrelated Investment Restrictions*

Our comments on borrowing cash and use of derivatives are set out above.

Physical Commodities—We agree that NRIF should be exempt from the provisions in Section 2.3 of NI 81-102 governing investment in physical commodities.

Short Selling—We do not agree with a restriction on short selling for alternative funds and NRIFs. We have a similar concern with a restriction on short selling as we expressed above in respect of the proposed concentration and illiquid asset restrictions. Capping short sales without consideration of a fund's terms and conditions and investor expectations, we submit, may impose the same unwarranted costs on investors noted above. Investors will bear the cost of portfolio liquidity that they neither need nor expect.

We also note that the Proposed Amendments have an implicit bias to the use of specified derivatives. The leverage cap for short sales is 50% of NAV. However, the leverage cap for specified derivatives is 3 times NAV. But funds can use specified derivatives (i.e. equity swaps) to take a short position rather than entering into a physical short.

Question 15—Point of Sale

Mutual funds, ETFs and listed alternative funds will all be able to transact on a summary point of sale document. We do not see the policy rationale to restrict NRIFs and unlisted alternative funds from also using a point of sale document. This proposal seems inconsistent with the CSA's efforts to harmonize disclosure regimes.

Question 16—Transition

We reiterate our submission that all existing NRIFs and commodity pools should be grandfathered from the Interrelated Investment Restrictions. Existing NRIFs should continue to be able to conduct their business, operations and affairs in all respects in compliance with their constating or governing documents. In particular, they should continue to be able to issue securities. We believe that if investors or their advisors wish to move to products governed by the new NI 81-102 regime, they have the choice to sell or redeem their units/shares of grandfathered funds and purchase new products.

Requiring a transition period for NRIFs is inappropriate as it would create substantial confusion and uncertainty for investors since it is unclear how the transition would impact the relevant fund in terms of costs and ability to continue and possibly compromise their ability to report historical performance. Furthermore, and more importantly, investment fund managers created and marketed these funds and investors purchased these funds on the basis of their current structure and it is not clear why this agreement should be abrogated. It is important that the CSA provide clarity regarding grandfathering as

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[4] Available at: https://www.google.ca/search?q=SEC+derivativex+blunt+instrument&oq=SEC+derivativex+blunt+instrument&aqs=chrome..69i57.11843j0j4&sourceid=chrome&ie=UTF-8.

[5] Available at: http://www.sifma.org/issues/item.aspx?id=8589959548.

soon as possible as we have concerns that the prevailing uncertainty may have a chilling effect on the NRIF market and we do not believe that this is what the CSA intended by the Notice.

Part II **Other Comments**

(a) Definition of Illiquid Assets

As we stated in our Previous Comment Letter, we believe the definition of "illiquid asset" must be updated before it is extended to other fund types.

In particular, the CSA needs to clarify that asset classes such as OTC derivatives, syndicated loans, corporate bonds and emerging-market sovereign and quasi-sovereign bonds that trade primarily over-the-counter are not illiquid assets. Although these institutional markets have no public quotations in common use that are widely available to retail investors, they are nonetheless very liquid markets.

Alternatively, we would support the US approach under Rule 22e-4 adopted by the United States Securities and Exchange Commission on October 13, 2016.[6] Under Rule 22e-4, an illiquid investment is an investment that the fund reasonably expects cannot be sold in current market conditions in seven calendar days without significantly changing the market value of the investment.

(b) Counterparty Requirements

We do not support the removal of the exemption for alternative funds and NRIFs from the exposure limits under section 2.7(4) and section 2.7(5) of NI 81-102, or the addition of section 2.1(1.1) of NI 81-102 as it applies to prepaid specified derivatives. A prepaid specified derivative means that, upon entering into the transaction, the investment fund pays all of its obligations up front and therefore has no further obligations under the transaction. These types of transactions are beneficial to investment funds.

In fact, we would support an exemption for any investment fund from section 2.1, section 2.4, section 2.7(4) and section 2.7(5) of NI 81-102 (the "**Applicable Sections**") with respect to a prepaid specified derivative transaction, as long as (i) the investment fund's counterparty has a designated rating at all times, and (ii) the counterparty's obligations under the prepaid specified derivative transaction are fully collateralized. For this purpose, the term "fully collateralized" means that the collateral held by the investment fund plus the prepaid specified derivative is marked-to-market on a weekly basis and the amount of collateral will be adjusted each week to ensure that the market value of the collateral held by the investment fund, when adjusted, will be equal to the mark-to-market value of the corresponding prepaid specified derivative. We submit that, as long as those two conditions are met, the investment fund is fully protected and should not be prevented from entering into a prepaid specified derivative which would otherwise contravene the Applicable Sections.

(c) Alternative Fund/Redemptions

We think that an alternative fund should have the flexibility to be either a mutual fund or a NRIF. Practically, in order to be listed, an alternative fund could not be redeemable on demand. Such a fund would be able to adopt the redemption feature of a NRIF with an annual redemption at NAV. We also think that an unlisted alternative fund should be able to adopt a redemption frequency of its choosing such as monthly, quarterly or semi-annually.

(d) Transforming NRIFs into Mutual Funds Carries a Cost

In the Notice, the CSA concluded that "Not proceeding with the Proposed Amendments in respect of the Interrelated Investment Restrictions would not be appropriate in view of both investor protection and fairness concerns, since this would permit some NRIFs to potentially operate in a manner that is inconsistent with other investment funds."

[6] Available at: https://www.sec.gov/rules/final/2016/33-10233.pdf.

And yet no evidence is offered as a basis to support this view. Fairness to whom? Investors that will necessarily have their choice of investment products reduced? Managers whose products are being limited on the basis of investor protection where no evidence of investor loss is provided? Operating in a manner inconsistent with other investment funds is precisely why NRIFs exist. To try to transform NRIFs into listed mutual fund-like products is to regulate so as to create a product that does not exist today and for which there is no evidence of investor need, expectation or, for that matter, appetite.

While many market participants supported the "Core Operational Requirements" introduced in 2013, they also questioned the rationale for the CSA proceeding with the Interrelated Investment Restrictions. The CSA has not provided any empirical fact-based evidence of its cost-benefit analysis, but concludes nonetheless that they "do not believe that the proposed Interrelated Investment Restrictions would create substantial costs for non-redeemable investment funds".

In the absence of grandfathering, this conclusion will not be true for existing NRIFs that do not comply with the proposed Interrelated Investment Restrictions. That NRIFs operate in a manner that is "inconsistent with" mutual funds is the reason they evolved in the first place. This difference is not a negative side-effect of a lack of a regulatory intervention, but instead empirical evidence of the fostering of a fair and efficient capital market. We anticipate that the real cost will be the long-term viability of NRIFs as an asset class as a result of reduced investor choice, product innovation and capital raising.

****

Thank you for the opportunity to comment on the Proposed Amendments. We look forward to continued dialogue and consultation with you as these proposals are refined. We would be pleased to meet with the CSA to discuss our suggestions in person to provide additional context and background based on our consultations.

Sincerely,

(Signed) Jeffrey L. Glass
Partner
Blake, Cassels & Graydon LLP

(Signed) Darin R. Renton
Partner
Stikeman Elliott LLP

IRWIN, WHITE & JENNINGS

BARRISTERS AND SOLICITORS

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December 22, 2016

BY ELECTRONIC MAIL

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
Registrar 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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Me Anne-Marie Beaudoin
Corporate Secretary
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E-mail: consultation-en-cours@ lautorite.qc.ca

Dear Sirs/Mesdames:

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

We are counsel to GrowthWorks Capital Ltd. ("GWC") which is the manager or portfolio manager of certain labour-sponsored investment funds ("LSIFs") including the Working Opportunity Fund (EVCC) Ltd. ("WOF") and GrowthWorks Atlantic Venture Fund Ltd. ("AVF").

We are writing on behalf of GWC to provide comments on Proposed Amendments (as defined in the above referenced CSA Notice and Request for Comment). Our client appreciates the opportunity to provide input on this regulatory process.

BACKGROUND

GWC is registered as a portfolio manager under securities laws in the provinces of Nova Scotia, Ontario, Manitoba, Saskatchewan and British Columbia, a mutual fund dealer under securities laws in the provinces of Nova Scotia, Ontario, Saskatchewan and British Columbia, an exempt market dealer under securities laws in the provinces of British Columbia and Ontario and an investment fund manager in British Columbia.

WOF is an employee venture capital corporation ("EVCC") registered under the *Employee Investment Act* (British Columbia) and is a prescribed labour sponsored venture capital corporation under the *Income Tax Act* (Canada).

AVF is registered as a labour-sponsored venture-capital corporation under the *Income Tax Act* (Canada), the *Equity Tax Credit Act* (Nova Scotia) and the *Labour-Sponsored Venture Capital Tax Credit Act* (Newfoundland and Labrador) and is a prescribed registered labour-sponsored venture capital corporation under the *New Brunswick Income Tax Act*.

Created as special investment vehicles to encourage greater risk capital investment in small and medium size businesses to foster new business formation and stimulate economic development, LSIFs operate in a qualitatively different environment than other investment funds. As with previous comments on proposed legislation and exemptive relief applications, we believe it is important to highlight the following critical differences between LSIFs and other more traditional investment funds:

- *The Goal of the LSIF Program* - In the late 1980's and early 1990's, the federal government and the governments of Ontario and British Columbia recognized that traditional capital markets were not providing sufficient venture capital for small and medium sized (mostly private) businesses in Canada. The LSIF program was created as a special investment vehicle to encourage greater risk capital investment in small and medium size businesses to fill this void and foster new business formation and stimulate economic development. The program has been successful in targeting investor capital into small and medium size businesses that has not been matched by traditional mutual funds in Canada. In the 2016 budget, the federal government recognized the continuing importance of the this program by reinstating the federal tax credit for LSIFs registered in provinces that have LSIF programs such as British Columbia, Nova Scotia, New Brunswick and Newfoundland and Labrador.

- *Nature of Venture Capital Investing* - Venture investing can best be described as active, value-added investing of patient capital. A typical venture investment takes 3 to 10 years to mature, during which time the fund's investment manager is actively involved in assisting the investee company to grow and develop, usually by participating at the board level and in sourcing additional financing. Typically, a venture investor will take a significant minority

interest in the investment, often more than 10%. This type of investing is markedly different than more traditional mutual fund investing. Mutual fund investments generally can be characterized as shorter term, passive investing without a significant stake in the companies in which the mutual fund invests and without board representation. Long-term investing requires access to long term capital, which has been recognized by LSIF governing legislation which requires investors to repay both the federal and provincial tax credits if they sell their LSIF shares prior to eight years.

- *Type of Investee Companies* - Labour-sponsored venture capital corporations like WOF and AVF are subject to detailed requirements on the kind of investments that they may make. Under these requirements, LSIFs are required to invest the majority (typically 60-80%) of the capital it has raised in eligible small and medium sized businesses that are typically not public companies. If these investment requirements are not met, LSIFs face potential penalties/taxes. Venture capital investments are typically minority positions in private companies which are not immediately saleable and it takes some time for exit opportunities to arise. Because of this, forced sales of venture investments prior to exit opportunities arising generally result in exit values that are significantly lower than prevailing carrying values, which in turn, result in portfolio losses. This means that venture capital funds like WOF and AVF rely to a significant extent on favourable merger and acquisition and initial public offering market conditions for full value, cash generating exit events, conditions over which they have no control.

- *Valuation of Investee Companies* Venture investments are typically in "emerging private companies" meaning they do not have profits or positive cashflows - they do not have listed prices and are not amenable to conventional valuation methods. As such, WOF and AVF, like most LSIFs, have adopted detailed valuation rules that are consistent with the Canadian Venture Capital and Private Equity Association (CVCA) Valuation Principles and Guidelines to value their venture investments. The carrying values generated are reviewed annually by an independent chartered business valuator. Under these rules, venture investments are valued at estimated fair value being the price that would be received to sell an investment in an orderly transaction between arm's length market participants at the valuation date using the method of valuation which best and most objectively reflects such fair value. Typically investments are valued at cost for the first year, and thereafter, based on valuation events such as a recent significant arm's length, bona fide, enforceable offer or transaction. Valuation events may result in a particular investee company making up a significantly larger proportion of a fund's net asset value ("NAV") and this impact may be magnified in situations where a fund is pursuing divestments as part of an orderly realization of value.

- *Adverse Consequences of not participating in Follow-on Financings* - Follow-on investing is a key element of the venture investment cycle. Typically a fund does not provide initial funding that will support the portfolio company throughout the investee company's entire development cycle. Often multiple rounds of follow-on financing are completed at different stages of the company's development before a company is generating income to finance its own operations or until an exit opportunity arises. If any investor, including a LSIF, does not participate in follow-on rounds of financing, either by choice or due to investment restrictions, the investor faces a number of negative consequences, including:
    - having its investment significantly diluted if the follow-on round is completed at a lower price than prior rounds;
    - incurring "play or pay" penalties whereby syndicate members that do not participate in follow-on rounds of financing are penalized through, for example, the loss of anti-dilution rights, the loss of board seats or forced conversion of preferred shares into lower-ranking classes of shares; and
    - losing the value of the investment entirely if the portfolio company cannot secure needed financing from alternative sources.

These above noted fundamental differences have been recognized by securities regulators in three specific ways:

(1) in the form of orders that exempt LSIFs from many of the investment restrictions that were formulated with conventional mutual funds in mind;

(2) in the form of an express conflicts provision within NI 81-102 as set out in section 1.2(4) which expressly states that to the extent a provision of NI 81-102 conflicts with or is inconsistent with a provision of the EIA or the *Small Business Venture Capital Act* (British Columbia), the provision of the EIA or the *Small Business Venture Capital Act*, as the case may be, prevails; and

(3) by way of regulation of a specific commission such as regulation 240 of the Ontario Regulation expressly exempts LSIFs from the requirements of a rule, policy or practice of the Ontario Securities Commission that conflicts with a provision of the *Labour Sponsored Venture Capital Corporations Act*, 1992 [now the *Community Small Business Investment Funds Act*].

We submit that this special context of LSIFs should be duly considered when forming securities regulatory policy applicable to these particular funds. This may mean in some instances that a "one size fits all" approach will not be appropriate.

COMMENTS ON THE PROPOSED AMENDMENTS

We have limited our comments to items most relevant to LSIFs and as such have provided select comments on the Proposed Amendments as set out below.

Status of Current Exemptive Relief

We seek clarification on behalf of GWC as to the status of currently existing exemptive relief for LSIFs.

In this regard, we note that AVF, like most other LSIFs, has received exemptive relief from a number of sections of NI 81-102 as follows: from sections 2.2, 2.3(g), 2.4, 2.6(d) and (f), 4.2(1)4, 5.5(1)(d), 7.1, 10.2(5), 10.3 and 10.4(1) of NI 81-102 pursuant to decision letter dated January 7, 2005 of the Nova Scotia Securities Commission ("NSSC"); from sections 2.1, 2.6(a) and (h) of NI 81-102 pursuant to decision document of the NSSC dated March 2, 2009; and from sections 7.1 and 5.5(1)(d), both revised from the 2005 relief, pursuant to decision document of the NSSC dated December 24, 2015.

We note that the LSIF regulatory environment in which AVF operates as an LSIF that necessitated AVF seek the exemptive relief in the first place has not changed. Requiring LSIFs like AVF to seek additional relief under the Proposed Amendments for exactly the same reasons as previously granted relief would result in unnecessary cost to the fund, which costs are ultimately borne by its shareholders, without a tangible benefit. As such, we respectfully submit that relief previously granted to LSIFs such as AVF should be grandfathered under any proposed changes to NI 81-102.

Notwithstanding our submission regarding the grandfathering of previously granted exemptive relief, we seek confirmation on two matters of interpretation with respect to such previously granted relief.

The first matter we seek confirmation on as a matter of interpretation is the impact of the introduction of a subsection when a fund has been granted exemptive relief from the section generally. For example, as noted above AVF has been granted exemptive relief to section 2.1 with no reference to one or more particular subsections. It would seem that the relief would apply to section 2.1 in its entirety including any subsection of 2.1 subsequently introduced such as proposed subsections 2.1 (1.1).

The second matter we seek confirmation on as a matter of interpretation is with respect to agreements with third parties that have been entered into based on exemptive relief for a particular subsection when a new subsection is proposed that the previously entered into agreement does not comply with. We seek confirmation that such a proposed subsection would be applied by the CSA on a go forward basis, and therefore a fund would not be viewed as being in non-compliance with it for previously entered into agreements or actions.

Section 2.1 Concentration

The Proposed Amendments include a new section 2.1(1.1) that applies specifically to non-redeemable investment funds and alternative funds. The CSA has also identified the following specific issue for comment with respect to section 2.1(1.1) of NI 81-102 requested that:

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 noted above, AVF has been granted exemptive relief to section 2.1 with no reference to one or more particular subsections. It would seem that the relief would apply to section 2.1 in its entirety including any subsection of 2.1 subsequently introduced.

In the alternative, we submit that LSIFs such as AVF should not be subject to proposed section 2.1(1.1) either by way of grandfathering of previous exemption from section 2.1(1) or by express recognition in NI 81-102 because of the critical differences between LSIFs and other more traditional investment funds described above in *Background*.

AVF received exemptive relief in 2009 from the provisions of 2.1 based on the need to allow it to complete follow-on investments in investee companies to extend the timeframe for exit opportunities to arise so that AVF could pursue liquidating its investment positions as part of full value exits. These same reasons exist today and are even more relevant for AVF as it seeks to maximize the potential value of the existing portfolio and distribute cash to shareholders as part of an orderly realization of value under the Pro Rata Redemption Plan ratified by shareholders in 2016. Valuation events that occur from time to time may result in a particular investee company making up a significantly larger proportion of a fund's NAV and this impact is magnified in situations where a fund is pursuing divestments as part of an orderly realization of value. As noted above, if a LSIF does not participate in follow-on rounds of financing, either by choice or due to investment restrictions, then the LSIF faces a number of punitive consequences. As such, defensive follow-ons are important to preserve and potentially add value in any venture portfolio and the need to defend positions in promising companies is even more important when the number of investee companies in a venture portfolio is not expanding. Furthermore, given that venture capital investments are minority positions in private companies which are not immediately saleable and forced sales of venture investments prior to exit opportunities arising generally result in exit values that are <u>significantly</u> lower than prevailing carrying values, we submit enforcing a hard cap on concentration for LSIFs under section 2.1(1.1) would require LSIFs to "fire sell" investments at significantly lower values resulting in considerable adverse consequences for the funds, and therefore for their shareholders.

With respect to WOF, the EIA has a number of specific provisions with respect to concentration of investments (see for example section 16 *Control of Eligible Businesses* and section 19 *Aggregate Investment*) that limit WOF's investment in any particular company. As such, proposed section 2.1 (1.1) would conflict and/or be inconsistent with specific provisions of the EIA which pursuant to section 1.2(4) of NI 81-102 shall prevail. Therefore, we submit that so long as WOF complies with

the restrictions on concentration in the EIA, proposed section 2.1(1.1) would not apply with respect to investments by WOF.

Section 2.4 Illiquid Assets

The Proposed Amendments include new subsections for 2.4 (proposed subsections (4) to (6)) that apply specifically to non-redeemable investment funds. The CSA has also identified the following specific issue for comment with respect to these new subsections and requested that:

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).***

As noted above, AVF has been granted exemptive relief to section 2.4 with no reference to one or more particular subsections. It would seem that the relief would apply to section 2.4 in its entirety, including any subsection of 2.4 subsequently introduced.

In the alternative, we submit that LSIFs such as AVF should not be subject to proposed subsections 2.4(4) to (6) either by way of grandfathering of previous exemption from section 2.1(1) or by express recognition in the NI 81-102 because of the critical differences between LSIFs and other more traditional investment funds described above in *Background*.

AVF received exemptive relief in 2005 from the provisions of 2.4 because, in order to fulfill the policy initiative behind the LSIF program, AVF was required (and remains required) to invest the majority (typically 60-80%) of its capital in eligible small and medium sized businesses. As such, a very high proportion of AVF's investments would be, and are still today, invested in businesses that do not meet the liquid assets requirements of proposed subsection 2.4(4). If these investment pacing requirements under applicable LSIF legislation are not met, LSIFs face potential penalties/taxes.

These same reasons exist today and are even more relevant for AVF as it seeks to maximize the potential value of the existing portfolio and distribute cash to shareholders as part of an orderly realization of value under the Pro Rata Redemption Plan. The vast majority of AVF's investments are in venture investments which are illiquid. As venture investments are exited, it is expected that AVF will distribute available cash to shareholders under the Pro Rata Redemption Plan thus

maintaining the very high proportion of illiquid investments in the portfolio. Given that venture capital investments are minority positions in private companies which are not immediately saleable and forced sales of venture investments prior to exit opportunities arising generally result in exit values that are significantly lower than prevailing carrying values, we submit enforcing a hard cap on illiquid assets for LSIFs under proposed subsections 2.4 (4) to (6) would require LSIFs like AVF to "fire sell" investments at significantly lower values resulting in considerable adverse consequences for the funds, and therefore, for their shareholders. In addition, the proposed amendments would also have adverse consequences for AVF in terms of restricting follow-on investments. As noted above, if a LSIF does not participate in follow-on rounds of financing, either by choice or due to investment restrictions, then the LSIF faces a number of punitive consequence. As such, defensive follow-ons are important to preserve and potentially add value in any venture portfolio, with the need to defend Atlantic Fund's position in promising companies is even more important given that the number of investee companies in its venture portfolio is not expanding.

With respect to WOF, the EIA has a number of specific provisions that detail the specific types of investments that WOF can and cannot make or hold (see for example section 15 *Eligible Investments* and sections 22 *Permitted Investments*, section 16 *Investments for certain purposes prohibited*, section 17 *Control of Eligible Businesses*, section 18 *non-arm's length investments prohibited*, and section 19 *Aggregate Investment*) and what WOF must do in the event that an investment of WOF's becomes prohibited (see section 20 *Action to be taken if investment becomes* prohibited). As such, proposed subsections 2.4 (4) to (6) would conflict and/or be inconsistent with specific provisions of the EIA which pursuant to section 1.2(4) of NI 81-102 shall prevail. Therefore, we submit that so long as WOF complies with the restrictions on the specific types of investments that WOF can and cannot make or hold under the EIA and what WOF must do in the event that an investment of WOF's becomes prohibited, proposed subsections 2.4(4) to (6) would not apply with respect to investments by WOF.

We appreciate the opportunity to provide our comments on the Proposed Amendments most relevant for LSIFs and welcome the opportunity to discuss them further.

Best regards,

"Jill W. Donaldson"

Jill W. Donaldson

Cc: Derek Lew, President & CEO, GrowthWorks Capital Ltd.

INCLUDES COMMENT LETTERS

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VIA EMAIL

December 22, 2016

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

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Dear Sirs/ Mesdames:

Re: Modernization of Investment Fund Product Regulation – Alternative Funds Response to CSA Notice and Request for Comment ("Alt Fund Proposal")

Introduction

Wildeboer Dellelce LLP wishes to provide its comments to the Alt Fund Proposal published by Canadian Securities Administrators (the "**CSA**") on September 22, 2016. Wildeboer Dellelce LLP is a thirty lawyer business law firm based in Toronto which has a significant practice advising investment funds and portfolio managers, sponsors, dealers, lenders and investors in all manner of investment product offerings. We have been fortunate to have advised many managers of alternative products including assisting with the formation of pools of capital investing in hedge strategies, private equity, private lending, infrastructure, real estate, mortgages and fund-of-fund platforms. We believe that it is critical that such

products, properly constructed and suitable for individual investors, be made available more generally through registered mutual fund dealers across Canada. Below we set forth our specific comments to each of the questions posed by the CSA. In constructing this letter, we have consulted broadly with clients to provide you with as much technical and industry "colour" as possible but the comments themselves represent solely the views of the authors and the firm.

Structure of Regulation of Investment Funds

At the outset we feel that some consideration should be given to the regulatory "categories" of investment fund that are being created by the Alt Fund Proposals. Conventional mutual funds are the manner in which most (retail) individual investors participate in the public capital markets and at relatively small investment amounts can gain access to the skills of a registered portfolio manager. Such portfolio managers are able to construct and actively manage a diversified portfolio of public securities for small retail investors. More recently exchange traded funds ("**ETFs**") have provided to retail investors the ability to construct diversified portfolios which track various public market indices. These two types of mutual fund are the typical manner in which retail investors move beyond deposit products and seek investment returns.

In 2014 the CSA harmonized the rules governing closed-end investment funds ("**CEFs**") with much of National Instrument 81-102 ("**NI 81-102**"), and in particular certain provisions of Section 2 (Investment Restrictions). The Alt Fund Proposals liberalize further the investment restrictions applicable to conventional mutual funds, create another category of mutual fund but impose further investment restrictions to the operation of CEFs. For the reasons set forth below, we believe that (i) liberalized investment restrictions for conventional mutual funds should be permitted; (ii) the new category of Alternative Funds should be implemented as soon as possible; and (iii) the adoption of further investment restrictions in respect of CEFs is not appropriate for the reasons indicated below. We will address points (i) and (ii) under our responses to the specific questions posed by the CSA below. We did want to address point (iii) before addressing the CSA's questions.

Since the late 1980s, with the advent of significant issuances by CEFs in Canada, virtually all innovative asset classes and investment techniques have made available to retail investors in Canada through the CEF structure. The offering of CEFs permitted investment fund managers to refine offerings through a syndicate of investment dealers who assisted with the structure and description of the proposed offering. As such, dealers are liable under provincial securities legislation for the disclosure in the prospectus motivating careful consideration by them of the appropriate structures, governance and investment restrictions applicable to the operations of the CEF. The relatively high cost to establish such structures ensured that investment dealers were compensated for the work needed in their corporate finance groups to customize the offerings for sale to their clients. Since CEFs were not mutual funds it was not possible to sell the securities through the mutual fund dealer network. Instead such offerings were restricted to sale through investment dealers.

Among their advantages, these products permitted sponsors to hold less liquid assets and to engage in more sophisticated investment strategies through a listed vehicle than could be accommodated in mutual funds which needed to maintain daily or weekly liquidity under NI 81-102.

The successful use of such strategies in CEF offerings has directly led to liberalization of the rules in NI 81-102 relating to mutual funds. We have seen in the past 15 years a series of exemptive orders and then changes to NI 81-102 permitting broader use by mutual funds of a number of investment techniques including permitted derivatives, short selling, securities lending and repurchase/reverse repurchase agreements.

The Alt Fund Proposals are significant to the Canadian retail structured product market as they will permit certain asset classes and investment techniques to be available to retail clients through the mutual fund dealer distribution channel. As mutual funds, they will also be capable of being offered continuously and to being redeemed as frequently as daily at the net asset value per security. Subject to our comments below, we are supportive of the Alt Fund Proposals in the form they were published provided that the necessary regulatory regime applicable to mutual funds should not stifle necessary innovation of other retail structured products such as CEFs.

We believe that if investment restrictions of CEFs are not returned to their pre-2014 levels that the shortcomings in their high cost and narrow base of distribution will marginalize such offerings. We think this would have a significant negative effect on the offering of novel and innovative products in the future or that such offerings will only occur through other fund distribution platforms which do not provide the same level of investor protections. When addressing CEF investment restrictions, we believe that the CSA should rely exclusively on the role of market intermediaries, such as investment fund managers, portfolio managers and investment dealers, to design and deliver well-structured and well-described securities offerings.

CSA Request for Comment - Specific Questions of the CSA Relating to the Proposed Amendments

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?*

   The CSA has said that it is seeking to regulate mutual funds which either: (i) invest in "alternative asset classes"; or (ii) engage in certain investment techniques such as short selling, borrowing or non-hedging use of permitted derivatives. There is a risk that in using the term "Alternative Fund" that casual observers will believe that such funds invest only in alternative asset classes, such as private equity, infrastructure, private lending, mortgages or real estate strategies. The entire rule set proposed will permit limited access for such funds to alternative asset classes given the continued need for frequent liquidity at net asset value. ETFs are known as "beta" funds as they provide passive market returns. We believe that actively managed Alternative Funds with a more diversified set of investment strategies and techniques would be best labelled "Alpha 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.*

   The categories of alternative investment strategies are constantly expanding. Given the need for frequent redemptions at net asset value, it is likely that only commodity pools and certain hedge fund strategies will be able to utilize the Alt Fund Proposals. We discuss below certain circumstances where the Alt Fund Proposals will not permit commodity pools or certain hedge fund strategies to be performed in their most efficient form. If regulation of the investment

restrictions applicable to CEFs is returned its pre-2014 state then most alternative assets classes such as private equity, private lending, mortgages, infrastructure and real estate could be housed in such investment funds. This would allow CEFs to continue their role as a "financial services sandbox" for the retail structured products industry while protecting the investing public interest.

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.*

One of the fundamental characteristics of a mutual fund is to provide diversification to small retail investors. As one of the central tenets of mutual fund regulation since the 1970s, care should be taken in making Alternative Funds less diversified. The exceptions in section 2.1(2) of NI 81-102 should apply to all mutual funds, including Alternative Funds. It is also important to consider that raising the concentration restriction to 20% of net assets may still not permit Alternative Funds to engage in many alternative strategies which are both concentrated and illiquid.

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.*

Many forms of alternative investing typically utilize much higher levels of illiquid investments. This is certainly true for private equity, venture capital, private debt, infrastructure, real estate and mortgages. The design of any investment product always begins with attempting to match the liquidity of the underlying asset class (and the particular investment strategies utilized) to the promised liquidity of the investment fund's securities. Since Alternative Funds are mutual funds governed by NI 81-102 they must maintain a portfolio that is sufficiently liquid to meet this obligation continuously. Amending the rules for certain kinds of mutual funds (however well disclosed) may result in the misapprehension of certain products by certain investors. A far safer and more effective solution would be to permit Alternative Funds to hold up to 10% of their net assets in securities of investment funds not governed by NI 81-102. Such non-NI 81-102 investment funds could provide Alternative Funds with access to less liquid alternative asset classes while not exposing investors to liquidity risk.

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.*

As discussed above, we believe that it will only be "liquid alternatives", such as commodity pools and certain hedge fund strategies, that will be able to safely access the Alternative Fund regime. If the CSA permit Alternative Funds to redeem their securities more infrequently, this may permit certain additional strategies to safely utilize such platforms but such strategies will be less homogenous and less capable of being benchmarked on performance. This will make it more difficult to use point of sale documents and to use standard deviation as a useful measure of risk

(see also in this regard #14 below). Furthermore, any lengthening of the redemption cycle for Alternative Funds (being the notice required, the frequency of the redemption and the speed of settlement of redemption proceeds) may require certain changes to the *Income Tax Act* (Canada) which requires that all mutual fund corporations and certain mutual fund trusts provide redemption of their securities "on demand". On balance, it would seem a better course of action to have a single definition of "redemption on demand" for all mutual funds, whether conventional mutual funds or Alternative Funds, rather than having two types of mutual funds with different redemption cycles.

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).***

As suggested above, we are of the view that there should be no limitation on the percentage of illiquid assets held by a CEF. It should be left to the sponsor and underwriters to determine appropriate investment restrictions for a CEF based upon the liquidity of the underlying assets and the frequency of redemptions promised to investors. Having a clear distinction between the investment restrictions applicable to CEFs and Alternative Funds will permit other forms of alternative assets and strategies to be offered through investment dealer distribution. It could be expected that longer duration private lending, private equity, real estate, mortgages and infrastructure assets could be offered in this more flexible and customized format.

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.*

See our general comments at the outset of our letter and our specific observations to question #5 above. The annual redemption feature that has been observed by the CSA arose in the mid-2000s in an attempt to narrow the discount at which CEF securities traded relative to their intrinsic net asset value per security. It was utilized only in respect of offerings where the strategy could safely permit the CEF to meet this requirement. We think the correct way to view this is that the underlying liquidity of the proposed asset class should drive the appropriate investment restriction (not the other way round).

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.*

One of the principal drivers of the Alt Fund Framework is to provide greater flexibility and diversity in the instruments and strategies available to mutual funds governed by NI 81-102. To be able to accomplish this objective, Alterative Funds need to access ways of borrowing beyond what is offered by eligible custodians under section 6 of NI 81-102. With respect to conventional "cash" borrowing, we understand that imposing this requirement will materially raise the cost of these activities without providing material benefits. Generally speaking, the most expensive cash borrowing a fund can obtain is from a conventional custodian. It is to the economic benefit of investors to permit "cash" borrowing from entities beyond conventional custodians and, at a minimum, to ensure that investment funds with assets held through sub-custodian accounts outside Canada are able to avail themselves of cash borrowings from entities which qualify under Section 6.3 of NI 81-102. We understand that such measures would not create any incremental risks to the fund.

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.*

Conventional Mutual Funds

We believe one of the most overlooked types of investment fund impacted by the proposed leverage limit is "conventional mutual funds" that currently utilize specified derivative instruments within the existing regime under Sections 2.7, 2.8 and 2.9 of NI 81-102. One may think that a leverage limit would not impact conventional mutual funds because they, by design, are not to employ leverage. However, we understand that certain of such mutual funds would be offside the proposed three times leverage limit based on the proposed methodology of determining the leverage limit.

Under the current regime in Section 2.7 of NI 81-102, conventional mutual funds are able to use specified derivatives for hedging or non-hedging purposes, subject to the counterparty limit of 10% of net asset value in Section 2.7(4) (which limit is not currently based on the notional value of such permitted derivatives but rather the mark-to-market value). The use of "aggregate notional amount" to determine the leverage limit in the proposed Section 2.9.1(2)(c), without allowing for netting for hedging transactions, would mean that such conventional mutual funds would no longer be able to run certain strategies. Since these types of conventional mutual funds currently operate under the existing regime of Sections 2.7, 2.8 and 2.9 of NI 81-102, we assume the intent of the Alt Fund Proposals is not to force these conventional mutual funds to reposition themselves as Alternative Funds because of the leverage limit and methodology proposed in Section 2.9.1. As such, we wanted to point out that the three times leverage limit (and use of use of "aggregate notional amount" for specified derivatives) impacts not only existing commodity pools and CEFs, but also certain conventional mutual funds.

CEFs

We agree that the introduction of the Alternative Fund category, and putting appropriate parameters around the leverage they employ, is good for Canadian retail investors. However, subjecting Alternative Funds and CEFs to effectively the same leverage limit would be detrimental to CEFs and detrimental to the creative and innovative benefits that have historically flowed from CEFs. Put another way, given their narrower distribution through investment dealers and higher initial costs, we believe that if CEFs and Alternative Funds are subject to the same

leverage limit the impact will be that investment fund managers will cease to launch such offerings resulting in less innovative products being made available to retail investors.

The leverage limit (and its prescribed methodology) is one investment restriction in particular where CEFs and Alternative Funds should be treated differently. We recommend that the Alt Fund Proposals be revised such that the leverage limit (and its prescribed methodology) should not apply to CEFs at all. We believe the current process where market intermediaries, such as investment fund managers, portfolio managers and investment dealers, determine any applicable leverage limits for a CEF should be maintained. We recommend the same approach with respect to the proposed short-selling and borrowing limits of 50% of net asset value in proposed Sections 2.6(2)(d), 2.6.1(1)(c)(v) and 2.6.2. Among other reasons, because the type of investing strategies and investment instruments utilized by CEFs are incredibly broad and diversified, it is challenging to develop and implement one set of limits that apply to all CEFs. Letting market intermediaries design and deliver well-structured and well-described securities offerings, including the setting of any applicable leverage, borrowing and shorting limits, is the most appropriate way to regulate these types of investment restrictions for CEFs.

Notwithstanding our recommendation, if the CSA still wishes to implement borrowing, shorting and/or aggregate leverage limits on CEFs, we think that it is essential to the survival of the CEFs, as an innovative and creative investment structure available to retail investors, that the CSA set different and higher leverage, borrowing and shorting limits for CEFs than may be set for Alternative Funds. This issue can be address through a combination of: (1) an increased limit (e.g. four times instead of three times leverage limit for CEF and 150% shorting and borrowing limit for CEF); (2) permitting CEFs to offset or net hedging transactions, whether done via specified derivatives or shorting; and/or (3) allowing CEFs to prescribe their own methodology for determining leverage, borrowing, shorting limits/exposure and mandating that the methodology be set out in the CEF's offering documents.

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*?

We believe all investment funds should be allowed to include offsetting or hedging transactions to reduce its calculated leveraged exposure. We cannot think of any specific types of specified derivatives to exclude, but we defer to other commenters with more technical knowledge of the instruments utilized by portfolio managers. In discussions we had with our various clients, they thought the current definition of "hedging" was adequate.

The CSA's questions focus on a fund's aggregate notional amount of specified derivatives in connection with the proposed leverage limit and methodology under Section 2.9.1(1) and 2.9.1(2)(b), respectively. We believe that further consideration is required in respect of more than just the specified derivatives component of the aggregate limit and methodology. Below we have set out specific comments/issues we have with respect to each of the element of the methodology in proposed Section 2.9.1 and other related provisions.

Section 2.9.1(2)(a) – Borrowing

As "cash" borrowing is relatively straightforward, in terms of use and measurement, we are generally supportive of the methodology proposed in proposed Section 2.9.1(2) (a). The only item we want to comment on is addressed in our response to Item #8 above. We think that Alternative Funds (and CEFs) should be able to borrow from parties other than the custodian of such funds.

Section 2.9.1(2)(b) – Shorting

It is critical that when determining any aggregate leverage limit (e.g. Section 2.9.1(2)(b)) and any shorting limit (e.g. Section 2.6.1(1)(c)(v)) that short positions entered into for hedging purposes be excluded from the calculation of these limits. If for some public interest purpose such transactions cannot be excluded from the calculation, they should be permitted to be set off from the relevant "long" position in determining compliance with the relevant investment restriction.

The primary rationale advanced for these restrictions is to reduce risk and limit financial leverage to which the mutual fund and its investors are exposed. With respect to reducing risk and shorting, revising proposed Sections 2.9.1(2)(b) and 2.6.1(1)(c)(v) to include an exception for hedging, would mean that a mutual fund could only rely on such exception where the short position offsets or reduces a specific risk or price change in accordance with the definition of "hedging" in NI 81-102. The Instrument already contemplates this distinction in the utilization of specified derivatives for hedging and non-hedging purposes and such rationale should extend to include the ability of a fund to effect short sales in order to accomplish the same objective. Any short position entered into for a hedging purpose is designed to reduce, not increase, risk created by an offsetting long position. Excluding such short positions from these limits seems logical and justified based on the public interest goals of the investment restriction.

Section 2.9.1(2)(c) – Specified Derivatives

Whether conventional mutual funds, Alternative Funds and CEFs are subject to the same or different limits in respect of aggregate leverage, it is critical for all such investment funds that when determining any aggregate leverage limit that specified derivatives used for hedging purposes be "offset" or "netted out" (e.g. Section 2.9.1(2)(c)). The issue arises because the methodology in the proposed Section 2.9.1(2)(c) currently uses "the aggregate notional amount of the investment fund's specified derivative positions" (emphasis added).

Certain investment funds (including conventional mutual funds) that run arbitrage or hedge based strategies utilizing specified derivatives often gain exposure to certain long positions and/or hedge their portfolio positions by utilizing permitted derivatives. This "lower risk" strategy seeks to take advantage of mispricing between securities of the same or similar issuers or in credit arbitrage portfolios to hedge out interest rate risk. These strategies are among the most likely to be introduced under the Alt Fund Proposals. Unfortunately if the three times leverage limit and/or the methodology adopts the use of "aggregate **notional** amount", existing strategies would need to be abandoned and the objectives of the Alt Fund Proposals largely blunted. The practical reality is that most over the counter derivative contracts enable parties to novate or net out mark-

to-market price movements and to set-off other obligations such that the financial risk to a fund is measured as the aggregate margin posted with a counterparty from time to time. This aggregate margin is composed of the initial margin on the trade date and the variable margin posted under the terms of the contract. The aggregate margin permitted to be on deposit with any one counterparty is currently limited to 10% of the net assets of the fund. The proposal to use aggregate notional amount relies on the spot price of the underlying asset on the trade date and does not represent a meaningful ratio for the purpose of measuring the real financial exposure of the fund. Based on our experience and discussions with clients, we believe this risk would be mitigated, if not eliminated, for most of these strategies if the methodology in the proposed Section 2.9.1(2)(c) is revised to allow the fund to continue to utilize mark-to-market calculations when using specified derivatives for such purposes. Furthermore it may be that the leverage calculations for Alternative Funds and CEFs should differ as would beget a gradual adoption of such investment techniques by mutual fund managers of Alternative Funds.

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.*

    Please see our responses to items #9 and #10 in respect of other considerations related to specified derivatives.

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.*

    Given their narrower distribution through investment dealers and higher cost, we believe that the proposed narrowing of the investment restrictions for CEFs will result in fewer less innovative offerings. If investors (or more frequently their advisors) wish exposure to alternative asset classes it will be left to offerings of at-risk notes, segregated funds or non-investment funds to provide such offerings. In the case of certain such offerings, retail investors will not enjoy the benefits of corporate finance review and underwriter liability.

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.

We think the Alt Fund Proposals in this regard are useful but will require periodic review to ensure these legends are helpful for readers.

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?*

Depending upon the alternative strategies employed, different risk measures have been found helpful. We think however that a single measure of risk across all retail mutual funds is an important regulatory objective as it fosters helpful benchmarking and comparisons. It is our understanding that the shortcomings to the use of standard deviation to the strategies to be housed in Alternative Funds are not significant and are outweighed by the advantages to a single measure of risk.

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.*

We are unaware of any such challenges.

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.

If the investment restrictions applicable to CEFs are not returned to pre-2014 levels we believe serious consideration should be given to not applying section 2 of NI 81-102 to any CEF formed before publication of the Alt Fund Proposals. These funds have delivered returns to investors consistent with their offering documents and in the event they no longer meet investor expectations they can be sold over a securities exchange or periodically redeemed at their net asset value per security.

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We trust that the foregoing is helpful to you in your deliberations. Should you have any questions concerning the above please do not hesitate to contact the undersigned.

Yours truly,

"Ronald Schwass"	*"Geoffrey Cher"*	*"Nick Gray"*
Ronald Schwass	Geoffrey Cher	Nick Gray

ARROW CAPITAL MANAGEMENT INC.

December 22, 2016

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

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Me Anne-Marie Beaudoin, Corporate Secretary
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RE: Canadian Securities Administrators ("CSA") Notice and Request for Comment Modernization of Investment Fund Product Regulation – Alternative Funds (the "Proposed Amendments")

Arrow Capital Management Inc. ("Arrow") supports the CSA's objective to move most of the regulatory framework currently applicable to commodity pools under NI 81-104 into NI 81-102 and rename these funds as "alternative funds". Arrow feels particularly supportive of the AIMA Canada's comments on the Proposed Amendments listed below, and in some cases have added further relevant commentary.

1. General Comments

AIMA Canada strongly supports the initiative to make alternative funds available to retail investors in Canada under National Instrument 81-102 Investment Funds ("NI 81-102" or the "Instrument") and we feel that, overall, the CSA have made a highly commendable effort in striking the appropriate balance amongst the investment restrictions, disclosure requirements and proposed distribution channels for alternative funds. However, we believe that there are several modifications to the Proposed Amendments and some additional amendments which, if adopted, will assist in fully realizing the goal of modernizing the existing commodity pool regime and providing Canadian retail investors with access to more innovative investment strategies in a manner which is efficient as well as appropriate from a risk perspective.

In considering comments received and potential changes to the Proposed Amendments, we urge the CSA to keep in mind the impact of any new requirements or regulations on the structuring and operating costs of smaller investment managers who may wish to offer investment products under NI 81-102. If the bar to entry is set too high, it would be prohibitive for the majority of the smaller investment managers to contemplate providing alternative funds to retail investors in Canada and only the largest institutions, such as Canadian banks and large mutual fund companies that have the resources and existing distribution networks would end up benefiting from the Proposed Amendments.

2. CSA Questions

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?

Response:

AIMA Canada agrees with the replacement of the term "commodity pool" with "alternative fund" and with the use of the term "alternative fund" in NI 81-102. The term "alternative fund" and the associated definition of this term in the Proposed Amendments is more representative of the various types of investment strategies that can be implemented in this category of investment funds.

Under the Proposed Amendments the CSA has proposed to adopt a similar approach to the definition of "alternative fund" in NI 81-102 as is currently used to define a "commodity pool" in NI 81-104. We would recommend that the definition of "alternative fund" be slightly modified

as follows to more closely parallel the stated approach of the Proposed Amendments and account for the operational distinctions between alternative funds and conventional mutual funds:

> "alternative fund means a mutual fund**, other than a precious metals fund,** that has adopted fundamental investment objectives that permit it to invest in asset classes**, ~~or adopt~~ use** investment strategies **or implement operational features that are not permitted by this Instrument ~~that are otherwise prohibited~~** but for **certain** prescribed exemptions **~~from Part 2 of~~ contained in** this Instrument;"

We would also like to bring the CSA's attention the fact that there are a number of conventional mutual funds that are currently offered that incorporate the terms "Alternative" or "Liquid Alternative" in the name of the fund. As part of the Proposed Amendments, we would expect that guidance on this point would be included in the Companion Policy to NI 81-102 that these funds would either have to convert to an alternative fund or be required to change their fund names to remove these references in order to avoid potential confusion with new alternative funds among investors. Similarly, new investment funds offered under NI 81-102 should not be permitted to use the word "alternative" in their fund name in a manner that suggests that they are an alternative fund in order to prevent confusion in the market.

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.

Response:

Generally speaking, we believe that most traditional alternative investment strategies currently offered on a private placement basis to high net worth investors would be permitted (in some cases with minor modifications) under the definition of "alternative fund" and the investment restrictions contained in the Proposed Amendments. However, we note that the leverage limits on alternative funds in section 2.9.1 of the Proposed Amendments will negatively impact the ability of managed futures, relative value and global macro strategies to operate efficiently. In addition, as discussed in more detail below, the ability to offer market neutral strategies would be severely impacted and the single issuer shorting restrictions will significantly hamper alternative strategies that hedge risk through the use of instruments such as government securities and index participation units.

(a) Market Neutral Strategies Should be Eligible to be Offered as Alternative Funds

While not a separate asset class, market neutral is a common investment strategy that will be

particularly affected for alternative funds under the Proposed Amendments.

The investment objective of a market neutral strategy is to remove market risk (i.e. the risks of significant swings in the market) by balancing long and short positions in an effort to provide returns in all market conditions. A market neutral strategy can provide true diversification in an investment portfolio as it is intended to be uncorrelated to the market. However, in order to employ a true market neutral strategy, a fund must be permitted have short and long positions of up to 100% of net asset value ("NAV"). Given the maximum short position limit of 50% of NAV for alternative funds in Section 2.6.1(c)(v) of NI 81-102, it would be practically impossible for a true market neutral investment strategy to be offered as an alternative fund.

Although it may be technically possible for an alternative fund to replicate a market neutral strategy under the Proposed Amendments through a combination of short-selling and specified derivatives, such an approach would be inefficient and more costly to implement than a "pure" market neutral strategy.

We submit that market neutral strategies can play an important role in removing market risk in an investor's portfolio and should be eligible to be offered as an alternative fund under the Proposed Amendments. This could be accomplished by including a definition of "market neutral fund" in the Proposed Amendments as follows:

> "market neutral fund" means an alternative fund that has adopted a fundamental investment objective of maintaining a neutral exposure to a broad group of securities identified by sector, industry, market capitalization or geographic region through the use of long positions and short positions

A corresponding exception to the 50% of NAV short sale limit could then be included for market neutral funds which would permit such funds to have short positions up to 100% of NAV.

(b) Government Securities and IPUs Should be Exempt from Single Issuer Short Sale Limit

At present, there are exemptions from the concentration restriction in section 2.1 of NI 81-102 for government securities, index participation units ("IPUs") issued by investment funds as well as investment funds purchased in accordance with the requirements of section 2.5 of NI 81-102 (which would include exchange traded funds that do not qualify as IPUs). There are similar exemptions from the control restriction in section 2.2 of NI 81-102.

We submit that, as is the case for long positions, government securities, IPUs and securities of other exchange traded funds should correspondingly be exempt from the single issuer concentration limit of 10% of NAV of the fund contained in subsection 2.6.1(iv) of NI 81-102. Such a change would permit a greater variety of risk-reducing hedging strategies to be offered to retail investors in alternative funds.

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.

Response:

AIMA Canada supports the concentration limit of 20% of NAV for alternative funds measured as at the time of purchase. However, we do not support the introduction of an upper limit or hard cap on concentration. The imposition of a hard cap concentration limit could result in forced sales of assets with higher transactional costs at distressed prices which would not be in the interests of investors. We submit that not having a hard cap allows alternative funds to better manage an orderly unwind of positions in excess of the 20% concentration limit thereby maximizing disposition proceeds and contributing to a lower level of market volatility.

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.

Response:

AIMA Canada submits that the illiquid asset limit for alternative funds be raised to 15% of NAV (with a hard cap of 20% of NAV). We believe that these increased limits would permit much more flexibility for alternative investment strategies and allow for exposure for retail investors to additional alternative asset classes under NI 81-102.

In connection with the Proposed Amendments, we would strongly encourage the CSA to use this opportunity to clarify the definition of "illiquid asset" in NI 81-102. The definition currently includes such terms as "readily disposed of", "market facilities", "public quotations" and "restricted securities" that are not defined and in respect of which there is no broad consensus within the industry. As such, the term continues to be difficult to interpret and apply in practice, particularly in respect of significant asset classes including syndicated loans, high yield debt, corporate bonds and emerging-market sovereign and quasi-sovereign bonds that trade primarily in the over-the-counter markets ("OTC").

We submit that the CSA should amend the definition of "illiquid asset" to expressly include OTC pricing that is determined on an arm's length basis and remove references to market

facilities and public quotations to better reflect industry practices with respect to these types of securities. In the alternative, we submit that the CSA should adopt the approach taken by the United States Securities and Exchange Commission ("SEC") for open-ended funds under Rule 22e-4 adopted by the SEC in an October 13, 2016 release ("Release") [available at: https://www.sec.gov/rules/final/2016/33-10233.pdf]. Under Rule 22e-4, an illiquid investment is an investment that the fund reasonably expects cannot be sold in current market conditions in seven calendar days without significantly changing the market value of the investment. This definition replaces longstanding SEC guidance that a fund asset should be considered illiquid if it cannot be sold or disposed of in the ordinary course of business within seven (7) days at approximately the value ascribed to it by the fund. The two components of the SEC liquidity test: (a) the number of days required to achieve liquidity and (b) a sale price that is not significantly different from the market value of the investment, we submit, are more relevant than nature of the market or quotations associated with such liquidity.

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.

Response:

Generally speaking, we submit that liquidity is of little relevance or concern where an alternative fund or a non-redeemable investment fund have limited redemptions and of no relevance or concern where such a fund is not redeemable. Our view is consistent with the International Organization of Securities Commissions ("IOSCO") principles on liquidity. The alignment of liquidity with the redemption obligations and other liabilities of open-ended funds is a principle recommended in IOSCO's "Principles on Suspensions of Redemptions in Collective Investment Schemes" [available at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD367.pdf] and reiterated in a report published in March 2013 entitled "Principles of Liquidity Risk Management for Collective Investment Schemes" in which they recommended fifteen principles [available at http:// www.iosco.org/library/pubdocs/pdf/IOSCOPD405.pdf.]

Redemptions and NAV Calculation

We would like 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 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. If a mutual fund is required to calculate NAV daily (as would be the case for many alternative funds), this would create a real difficulty 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 disconnect will exist 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 for the first or second business day provided for redemptions described above does not exist.

While we acknowledge that the Proposed Amendments do not prescribe any particular redemption frequency for alternative funds, the obvious problem for alternative funds offering weekly or even monthly purchases and redemptions as of a specific day ("Dealing Days") is that they will have multiple issue and redemption prices on any particular single Dealing Day as they will be required to calculate NAV on a daily basis and could potentially receive (purchase and/or redemption) orders each day of the week. Taken to its extreme, an alternative fund with a monthly Dealing Day may be required to issue securities at up to 30 different NAVs on the same Dealing Day.

If this issue is not addressed, the mismatching of the issue and redemption prices with the NAV on the particular Dealing Day will result in significant operational inefficiencies and confusion. Accordingly, we strongly encourage the CSA to correct this inconsistency. One possible solution would be 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** ~~**first or 2nd business day**~~ 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.

We would encourage the CSA to adopt a consistent approach for the purchase and redemption of securities of alternative funds similar to the approach to the payment of incentive fees in the Proposed Amendments (Section 7.1(2)). Specifically, an alternative fund should be required to

describe its purchase and redemption procedure in its simplified prospectus (including details relating to the frequency of purchases and redemptions).

Another example of the problem would be for alternative funds that adopt a "fund of funds" investment strategy as permitted under NI 81-102 and allocate all or a significant portion of the fund's investment portfolio to non-redeemable investment funds. It would be nearly impossible for such a fund to comply with the next NAV redemption requirements that would be applicable to alternative funds under the Proposed Amendments because of the infrequent redemption schedule of non-redeemable investment funds and the trading price (usually at a discount to NAV) being the only source of liquidity. Alternative funds would be better able to manage their redemption schedule if the redemption price payable is permitted to be based on the NAV at the regularly predetermined Dealing Day.

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.

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.

(a) *Prime Brokers*

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 ("NI 31-103"), 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.

We further submit that the alternative qualification requirement in Section 6.2(3)(b) of NI 81-102 that the bank has assumed responsibility for all of the custodial obligations of the dealer should remain unchanged.

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 the Investment Industry Regulatory Organization of Canada ("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.

(b) *Foreign Lenders*

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 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 **or 6.3**;"

(c) *Netting of Cash and Cash Equivalents*

We recommend that the proposed cash borrowing limit of 50% of NAV under the Proposed Amendments should be calculated net of any cash and cash equivalents held in the same account.

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.

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 pool. As the investment strategies of these existing funds were established to comply with the current regime, we recommend that these commodity pools be grandfathered in 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 through specified derivatives will result in the investment strategy used by the pool becoming wholly ineffective and requiring such commodity pools to cease operations.

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?

Response:

AIMA Canada has significant concerns at a global level regarding the proposal to restrict total exposure for alternative funds through borrowing, short selling or the use of specified derivatives to the proposed limit of 300% of the fund's NAV in section 2.9.1 of NI 81-102. As currently proposed to be calculated and coupled with a ceiling of 300% of NAV, the leverage limit not only would have a disastrous impact on some existing commodity pools, it would also have a significant negative impact on the ability to offer effective managed futures, relative value market neutral and global macro alternative investment strategies.

We would encourage the CSA to consider removing the hard leverage limit of 300% of NAV from section 2.9.1 and to instead require disclosure of the maximum amount of leverage the alternative fund may use and the method for calculating leverage by the alternative fund. Removal of the 300% leverage limit would permit existing commodity pools to continue to operate and would broaden the types of alternative strategies that could be made available to retail investors under NI 81-102.

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 would allow alternative funds to use these industry standard calculation methods for the purposes of calculating the fund's exposure under the Proposed Amendments. As set out in the companion policy to NI 81-102 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.

For the information of the CSA, we attach as Appendix "A" to this Comment Letter an AIMA White Paper comparing leverage measures in for investment funds between the United States and the United Kingdom.

Notwithstanding the above, if the CSA decide to retain the 300% of NAV total leverage limit in the Proposed Amendments we submit that alternative funds should be able to subtract or disregard certain offsetting transactions and positions in specified derivatives that do not create leverage to reduce their calculated leveraged exposure.

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 or to exclude all hedging transactions from the calculation of total leverage. Although, certain offsetting transactions described below should be specifically excluded

We recommend that immediate offsetting transactions in fungible securities that do not create any additional leverage or exposure and should be disregarded for the purposes of the calculation. By way of example, we note that IIROC Rule 100.4 addresses a variety of offsetting positions which are generally not included in the calculating leverage. The essential features of these transactions is that the long position is fungible into the short position and is convertible (however, any costs of converting the offsetting position would be included in the leverage calculation).

We also recommend that alternative funds, in determining the aggregate gross exposure, be permitted 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.

In addition, we recommend that the Proposed Amendments include a carve-out provision that would permit an alternative fund, in determining aggregate gross exposure, to disregard any

specified derivatives entered into for the purpose of specifically offsetting: (i) foreign currency exposure; (ii) interest rate exposure; and (iii) single-name credit exposure, as these transactions are entered into to eliminate economic exposure in whole or in part. The carve-out provision would permit an alternative fund to exclude from its aggregate gross exposure the notional amounts associated with specified derivative transactions that are entered into by the alternative fund to specifically offset foreign currency exposure or interest rate risk of the fund's portfolio assets, as well as single-name credit default swaps to offset the credit risk of fixed income securities issued by a single debt issuer.

A fund that wants to fully or partially neutralize the foreign currency, interest rate or credit exposure of specific investments by entering into a specified derivative should be able to disregard the notional amount of the offsetting transaction for the purposes of the fund's overall leverage limit.

Our proposed carve-out for these offsetting transactions is not designed to enable a fund to generally disregard the notional amount of specified derivative transactions involving foreign currency, interest rates or credit exposure. Rather, the provision would only apply to specified derivative transactions that directly offset or reduce risks associated with all or a portion of an existing investment or position of the alternative fund. These types of transactions do not create leverage or increase a fund's net exposure to leverage and are some of the most common specified derivative transactions entered into for the purposes of managing risk.

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.

Response:

Generally speaking we agree that the notional amount of a specified derivative does not always reflect the way in which the fund uses the derivative and that it is not a direct measure of risk. The obvious example being that two different specified derivatives having the same notional amount but different underlying reference assets may expose a fund to very different investment risks. AIMA's position is that there should be multiple (rather than a single) measures of leverage used in order to address the variability of strategies in the alternative investment universe, and that clear, plain and true disclosure be used to outline how leverage is being used to either enhance returns, or in many cases, to combine related securities in an effort to reduce the capital at risk in the portfolio.

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.

Response:

We submit that it may be difficult to include all of the information contemplated by the CSA for an alternative fund in the text box disclosure of the fund facts document and to still stay within the space constraints of the document. We suggest that it would make more sense to include a description of the asset classes and/or investment strategies used by the alternative fund that cause it to fall under the definition of "alternative fund" in NI 81-102 under the description of what the fund invests in the fund facts document and to use the text box disclosure to highlight any differences in the redemption terms for an alternative fund compared to a conventional mutual fund as well as the sources and uses of leverage, any specific risk factors that an investor should consider as a result of the asset classes invested in, or investment strategies utilized by the alternative fund to either enhance return or reduce specific risks in the portfolio. We submit that these changes would make the fund facts document significantly more meaningful to retail investors.

AIMA Canada strongly objects to any suggestion that alternative strategies may "affect investor's chance of losing money on their investment in the alternative fund" as was commonly the case for warnings included in the prospectus of commodity pools. Each alternative fund should be evaluated on the basis of the particular investment strategies and asset classes in which it invests and clear disclosure of any risks that should be considered in conjunction with such strategies or asset class should be made in the fund's disclosure documents. We note that to require any disclosure for alternative funds but not for non-redeemable investment funds or conventional mutual funds implies that alternative funds are riskier and more likely to lose money when this is not the case. We do not consider such a distinction to be warranted or appropriate.

AIMA Canada believes that investors should be provided with all meaningful information which should be considered prior to making an investment decision. Specifically, if the changes to the Proposed Amendments suggested in this comment letter are alternative funds may have different timing for purchases, redemptions and risk methodologies which should be highlighted for investors. We suggest that it would be extremely helpful to industry participants if the CSA

were to provide a pro forma alternative fund facts document for further consultation and comment prior to the final amendments coming into force.

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?

Response:

AIMA Canada believes that the Methodology should be consistent between conventional mutual funds and alternative funds. We also believe that fund managers should have the ability to consider risk measures other than standard deviation as long as this is disclosed to the investor. We would recommend that the Methodology be revisited and adjusted in conjunction with the finalization of the Proposed Amendments as several elements of the Proposed Amendments will impact the overall risk profile of the fund.

There will likely be challenges for some alternative fund managers in complying with the new risk classification rules published in final form on December 8, 2016 and we recommend that some further consideration be given to how risk classifications will apply to alternative funds prior to the publication of the final amendments to NI 81-102 in order to ensure that alternative funds will be able to properly calculate and disclose risk to investors.

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.

Response:

Although smaller investment managers may initially face challenges and increased expenses (compared to existing mutual fund managers) in meeting the requirements, AIMA Canada

believes that the three month transition period set out in the Proposed Amendments should generally provide an adequate amount of time to implement a point of sale disclosure regime.

4. 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.

Response:

AIMA Canada supports the proposed transition period of three months from the final publication date for alternative funds. However, we note that some existing closed end funds and commodity pools that are adversely impacted by the changes to the investment restrictions in the Proposed Amendments may require more time to bring themselves into compliance with the restrictions (assuming that they are not grandfathered).

5. Other Comments on the Proposed Amendments

In addition to our Responses to the specific questions posed by the CSA, AIMA Canada has the following comments on other aspects of the Proposed Amendments.

Counterparty Exposure Limits (Section 2.7(4))

We do not agree with the elimination of the counterparty exposure exemption for alternative funds and non-redeemable investment funds. It is not clear that there is any risk from exposure to a single counterparty that needs to be mitigated.

The following comment has been made by others previously, including ISDA in their comment letter dated October 17, 2002 on proposed amendments to National Instrument 81-102 Mutual Funds and, in particular, on those aspects of NI 81-102 relating to swaps [available at: http://www.isda.org/speeches/pdf/osc-com-letter101702.pdf].

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.

Custodians of Alternative Funds (Part 6 of NI 81-102)

Under the Proposed Amendments, alternative funds would be required to appoint a custodian for the assets of the fund in the same manner as conventional mutual funds and custodians/sub-

custodians of the assets of alternative funds would be required to adhere to the same requirements as custodians/sub-custodians of conventional mutual funds.

The operational reality for most alternative funds (arising from the frequency of trading, the amount of short selling conducted and the amount of borrowing and derivatives utilized by the fund) require the alternative fund to lodge the majority of its assets with one or more prime brokers. We submit that the proposal to require a separate custodian for the portfolio assets of an alternative fund does not provide any significant additional safeguards for the portfolio assets and would result in increased costs and operational complexities for alternative funds.

Prime brokers do not typically act as custodians for conventional mutual funds for several reasons including: (i) the qualification requirements under Section 6.2 of NI 81-102; (ii) the prohibition on custodians taking security over portfolio assets of investment funds in Section 6.4(3)(a) of NI 81-102; (iii) the prohibition on the charging of fees for the transfer of beneficial ownership of portfolio assets in Section 6.4(3)(b) of NI 81-102; and (iv) the requirements relating the segregation of assets in Section 6.5 of NI 81-102.

In addition, although not a requirement, prime brokers can offer their clients the most efficient and cost-effective services if they are able to rehypothecate the non-segregated assets held in their client accounts. This has not generally been an issue for conventional mutual funds due to restrictions on leverage in NI 81-102, but for alternative funds that will be able to borrow and short sell up to 50% of NAV, permitting rehypothecation of collateral would significantly reduce transaction costs. This may also even the playing field somewhat between alternative fund managers and larger mutual fund companies who may be able to garner preferential terms from prime brokers if rehypothecation were not permitted.

In this regard, we submit that the portfolio assets of alternative funds will not be subject to any greater level of risk of loss. Prime brokers must adhere to the requirements of IIROC relating to the taking of security (margin) and the segregation of assets and the prime brokerage relationship is governed by the terms of the prime brokerage agreement. We believe that in addition to the operational benefits and cost savings listed above there are sufficient safeguards in place to effectively protect client assets, specifically:

- Cash in a Prime Brokerage account is not segregated and may be used by the Prime Broker subject to limits set and monitored by IIROC. A Prime Broker is liable as a debtor to pay the alternative fund, as creditor, all such amounts.

- A Prime Broker holds all securities in its accounts for the alternative fund. In a cash account, all securities are fully paid for and are segregated (either in bulk with other client assets or specifically for an alternative fund if a bare trust agreement is entered into).

- In a margin account, alternative funds may borrow against portfolio securities to the extent of their margin value. The securities borrowed against, based on their margin value are not segregated by the prime broker. Short positions in the account that cannot be covered by available cash may also result in securities becoming un-segregated.

- Under IIROC rules, a prime broker may use only un-segregated securities in their business and only to the extent needed to cover a margin loan. For example, if a client has securities worth $1,000 in its Prime Brokerage account and owe $100 on a margin loan, the Prime Broker would only be able to use securities having a total margin value of $100. Prime brokers use these securities in the normal course of their business.

- IIROC regulations require firms to review its segregation at the account level each day and to correct any deficiencies (IIROC Rules 2000.4 to 2000.6). A Prime Broker must take immediate action to correct any segregation deficiency (IIROC Rules 2000.8-9).

We note that, as part of amendments proposed for NI 31-103 in July of this year, the CSA contemplated that registered investment dealers who are members of IIROC would be permitted to act as custodians in Canada for the assets of privately offered investment funds.

AIMA Canada respectfully submits that registered dealers who are members of IIROC and who otherwise meet the qualification criteria to act as a Custodian under Section 6.2 of NI 81-102 (specifically, the criteria in Section 6.2.3 (a) and (b), requiring $10 million of equity or guarantee by the parent bank) should be permitted to act as the custodian or sub-custodian of an alternative fund. We also reiterate our comment relating to borrowing above that the requirement in Section 6.2(3)(a) of NI 81-102 that dealers' financial statements "have been made public" should be removed.

Permitting prime brokers of alternative funds to also act as custodian of the fund would save costs (by eliminating additional counterparties) and would not subject the portfolio assets of the alternative fund to any additional risk as prime brokers qualified to act as custodians will have sufficient capital and must act in accordance with IIROC rules and guidelines when taking and realizing on security or in connection with the segregation of assets.

Custodial Provisions relating to Short Sales (Section 6.8.1)

Section 6.8.1 of NI 81-102 currently permits a fund to deposit up to 10% of NAV with a borrowing agent, other than its custodian or sub-custodian, as security in connection with a short sale (the "10% of NAV Limit"). In practice, a borrowing agent generally requires that the proceeds from the short sale, plus additional collateral be held as security. Under the current NI 81-102 aggregate short sale restriction of 20% of a fund's NAV, this practice results in the need for at up to two or three dealers/borrowing agents to facilitate and permit a fund to short the maximum 20% of its NAV.

However, the Proposed Amendments will permit an alternative fund to short up to 50% of its NAV, without any change in the custodial provisions set out in Section 6.8.1 which presents both practical and operational issues for alternative funds. For example, under margin rules established by IIROC, an alternative fund entering into a short sale transaction for an equity security eligible for reduced margin would be required to post 130% of the market value of the short position as margin (security). As a result, an alternative fund that wishes to take full advantage of the increased short sale limits (50% of NAV) would be required to deal with 7 separate borrowing agents (other than the custodian) in order to comply with the 10% of NAV Limit in Section 6.8.1. A similar situation would be experienced for other asset classes such as fixed income and FX forward transactions. This would not be practically feasible and would lead to operational and administrative inefficiencies and significantly increased costs for alternative funds including:

- the time and effort to evaluate and sign multiple prime brokerage/dealer arrangements will be significant and costly for alternative funds.
- Requirement for additional staff to manage daily operational activities such as margin, reconciliations, settlements and tax reporting
- greater costs from the fund administrator due to increased book-keeping and reconciliation requirements.
- smaller accounts would mean less leverage to negotiate favourable pricing and terms of service with prime brokers/dealers.
- the requirement to locate multiple suitable prime brokers may be challenging due to the size of the industry in Canada; and
- other solutions (such as the use of tri-party arrangements) that may allow an alternative fund to comply with the 10% of NAV requirement could be operationally challenging and add additional costs for the alternative fund.

We note that if prime brokers were permitted to act as custodians of alternative funds as we have suggested above, the current language in section 6.8.1 would function much more effectively. Notwithstanding this fact, we would submit that a 20% of NAV deposit limit with borrowing agents (other than the fund's custodian or sub-custodian) as security for short sales by alternative funds would provide alternative funds with the flexibility to engage the services of two or more prime brokers (other than their custodian or sub-custodian) in an effort to execute their investment strategies in a more efficient manner and to help alleviate potential counterparty risk.

Historical Performance Record (Part 15 of NI 81-102)

A number of AIMA members 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. Although, 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. Without this information, investors will not be able to obtain a complete picture of the skill of the alternative fund manager and the behaviour of the alternative strategies employed by the fund. AIMA Canada considers this information (with the relevant caveats) to be vital for investors who will not be familiar with this space.

Presentation of Financial Highlights in NI 81-106

We have the following specific comments relating to the presentation of financial highlights by mutual funds under NI 81-106.

Calculation of Management Expense Ratio and Trading Expense Ratios

We submit that due to the use of short selling and/or borrowing by alternative funds, the costs associated with such alternative investment strategies will significantly impact an alternative fund's expense ratio. As there is limited guidance on the inclusion of these expenses in either Management Expense Ratio ("MER") or Trading Expense Ratio ("TER"), we are concerned that there will be inconsistent treatment resulting in less comparability across different funds. Since these expenses, including dividend and interest expense on short sales and related short sale borrowing fees, as well as borrowing interest expense costs, are incurred in the course of execution of the alternative strategy, we recommend that the CSA provide guidance that confirms these expenses should be included as part of TER. Such treatment would be in line with other transaction costs which are currently included in TER, however it would treat interest expense on borrowing as TER rather than the current practice of including this expense as part of the MER. We submit that our recommended treatment of these expenses for alternative funds

would better align costs with the execution of the strategy (i.e. transactional in nature) rather than as an operating expense of the alternative fund.

Total return and total annual compound return calculations

NI 81-106 currently requires returns to be bifurcated and presented separately for long and short investments during the relevant period. We submit that the requirement to bifurcate long and short returns for alternative funds be removed as the current disclosure requirement would result in misleading information for investors both as it relates to fund performance as well as providing a complete understanding of the strategy and risk of the alternative fund. For example, various alternative strategies involve the execution of long-short "paired" trades or the use of short sales to hedge an element of market or interest rate risk such that the position is only relevant when one considers the combined long and short components. One must also take into account that specified derivatives are used by some alternative investment strategies instead of short sales to achieve a similar result. Thus, presentation of performance bifurcated between long and short positions will not allow an investor to understand the performance of the fund and will only promote misunderstanding and confusion.

Proficiency

We note that the CSA intends to engage with the Mutual Fund Dealers Association ("MFDA") in order to determine the appropriate proficiency requirements for dealing representatives of mutual fund dealers to distribute securities of alternative funds. AIMA Canada has a vast array of educational and other resources available relating to alternative investment strategies and we would be very pleased to offer our assistance to the CSA and MFDA in this regard.

We appreciate the opportunity to provide the CSA with our views on the Proposed Amendments. Please do not hesitate to contact us with any comments or questions that you might have.

Sincerely,

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December 22, 2016

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
Superintendent of Securities, Nunavut

Attention: The Secretary
Ontario Securities Commission
20 Queen Street West
22nd Floor
Toronto, ON 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 (Quebec) H4Z 1G3

Dear Sirs/Mesdames:

Re: CSA Notice and Request for Comments regarding proposed repeal of National Instrument 81-104 *Commodity* Pools ("NI 81-104"), proposed amendments to National Instrument 81-102 *Mutual Funds* ("NI 81-102") and Related Consequential Amendments under Modernization of Investment Fund Product Regulation (Phase 2 – Second Stage) ("Phase 2 – Second Stage")

Introduction

The proposed amendments to NI 81-102 while focused on alternative funds, include provisions that impact non-redeemable investment funds and in certain aspects reflect the comments submitted by market participants in 2013. In its current form, we believe that Phase 2 – Second Stage will have a negative impact on investors that have invested in existing non-redeemable funds that have proven successful track records.

Brompton Funds Limited ("Brompton") (or its predecessors) has been a manager of non-redeemable funds since 2002 and also offers flow-through funds, mutual funds and an accredited investor hedge fund. Brompton currently manages 15 non-redeemable funds. Brompton focuses on offering unique investment products with investor friendly terms complemented with strong corporate governance. We would like to take this opportunity to provide comments in response to Phase 2 – Second Stage given that its impact will change the non-redeemable fund ("NRF") space and we believe will negatively impact investors.

Summary

The proposed amendments in Phase 2 – Second Stage provide a regulatory framework for alternative funds. However, provisions that impact NRFs through the Interrelated Investment Restrictions would reduce investor choice, product innovation and the raising of capital and would create regulatory rigidity, increasing the pressure on the regulators for exemptive relief. The due diligence process which NRFs are subject to provides investors with an independent review of the investment product and structure to ensure that not only can the NRF meet its investment objectives using its investment strategies but also that the NRF provides investors with appropriate rights and protections.

Brompton believes that investors should have access to the widest possible choice of investment products as they seek to diversify their investments and to reduce their cost of investing. We believe that certain of the proposed changes in Phase 2 – Second Stage will reduce investor's choice of investment product and strategies and reduce competition in the asset management business thereby potentially increasing costs. We believe that certain of the investor protections under the proposed changes including those relating to investment restrictions and leverage could best be provided through clear prospectus disclosure and continuous disclosure requirements. In addition, if changes are made as proposed in Phase 2 – Second Stage without a grandfathering provision for existing NRFs we believe that there will be significant costs to comply with changes for funds (such as unitholder meeting costs and legal costs). Such changes will also likely cause a significant reduction in current distribution or dividend rates and the trading price of certain NRFs resulting in a significant reduction in the value of investor's assets. The reduction in value would be the result of the CSA changing the investment bargain under which investors' initially purchased a NRF. Certain Funds that will be affected have been successfully operating for over a decade.

Below we address the specific questions of the CSA relating to the proposed amendments that impact NRFs:

Investment Restrictions

Concentration

3. ***Question:*** *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.*

Response: We agree with the proposed 20% concentration limit for NRFs at the time of purchase. We do not believe that an absolute upper limit or "hard cap" on concentration should be introduced. If the concentration limit is breached as a result of market volatility, having an absolute upper limit may require an investment fund to sell securities in unfavourable market conditions and forced selling can result in significant undue losses.

Investments in Illiquid Assets

6. ***Question:*** *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).***

Response:

We believe that no limit on illiquid assets is required for NRFs. In general, NRFs are not constrained by the need to maintain certain levels of liquidity required by mutual funds as they generally offer annual redemptions and redemption notice periods of up to 60 days. As a result, NRFs are able to offer different investment strategies for investors and such strategies may include illiquid assets. Indeed, one of the reasons to use a NRF structure is to invest in illiquid asset classes that cannot otherwise be held in a redeemable fund. NRFs may also employ a limited redemption feature to address liquidity concerns. We recognize the risks of investing in illiquid assets and endeavor to structure funds that are able to meet annual redemption commitments. Fund structure, investment objectives, investment restrictions and prospectus disclosure are all subject to an independent due diligence process by independent investment dealers and legal counsel. We believe that additional disclosure requirements for illiquid securities may be warranted. For valuation, NRFs have set up procedures for valuing illiquid assets which include evaluations by independent audit firms on at least an annual basis.

In particular, the current proposed limits will likely prohibit the issuance of investment funds that invest in flow-through shares ("Flow-Through Funds). Many of the flow-through shares that are purchased by Flow-Through Funds are offered by private placement which carry a 4-month hold period and as a result are considered illiquid assets until the hold period is complete. Flow-Through Funds are designed to provide tax benefits for investors and have been offered for well over a decade.

In addition, the current definition of illiquid assets requires "public quotations in common use" in order for an asset to be considered a liquid asset. We suggest that the definition of "public quotation" be updated to cover all debt securities instead of only fixed income securities to recognize the well-established floating rate loan markets. We suggest the new definition to read: *"public quotation" includes, for the purposes of calculating the amount of illiquid assets held by an investment fund, any quotation of a price for a debt security made through the inter-dealer market.*

7. ***Question:*** *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.*

Response: Flow-Through Funds have no redemption feature and invest in flow-through shares to obtain tax benefits. For funds that do not offer a redemption feature, we believe there should be no limit on illiquid assets as there is no immediate need for liquidity.

Borrowing

8. ***Question:*** *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: Phase 2 – Second Stage proposes to only permit alternative funds and NRFs to borrow from entities that meet the definition of a custodian for investment fund assets in Canada. The effect of this restriction would be to significantly limit the sources of financing for NRFs, which would have the likely effect of reducing liquidity and increasing the cost of financing and ultimately the cost to investors. It is unclear whether this proposed change is meant to address a perceived risk associated with foreign lenders or Canadian lenders that are not financial institutions. In any event, if a fund is complying with the terms of the borrowing there should be no issue. If a fund is in breach, the terms of the loan agreement and related security will govern the rights of the parties. In a breach scenario it would be expected that the behavior of the lender will be the same whether it is a Canadian or foreign bank or financial institution. In all cases, the lender will attempt to enforce its rights under the applicable loan and security agreements. We propose that lenders be lenders that are subject to regulatory oversight within their country of business to provide assurance that their lending arrangements are offered on competitive commercial terms.

We do not believe that restricting the use of borrowings and leverage by NRFs is appropriate or necessary to ensure that the regulatory approach with respect to NRFs continues to adequately protect investors. The current framework is appropriate as the level and type of leverage for a given NRF is highly subjective and should be based on the determination of the asset class and applicable market participants. Phase 2 – Second Stage proposes no such difference and imposes an arbitrary 50% of NAV limit for borrowings. At this level, at least 2 of the NRFs managed by Brompton may exceed the 50% limit. These 2 funds both invest in debt securities that generally have less volatility than equity securities and are focused on fixed or floating income asset classes. We believe that NRFs should not be limited as to the percentage of borrowings as they are not constrained by the daily redemption requirements of a mutual fund and generally offer annual redemptions. NRFs also often provide for a redemption notice period of up to 60 days to permit adequate time to liquidate its portfolio on an orderly basis. As a result, NRFs are able to manage higher levels of leverage. In addition, the NRF structure, investment strategies and investment restrictions have been subject to the review of independent investment dealers to ensure that NRFs and their assets have manageable levels of leverage. NRFs are also able to obtain financing at more favourable interest rates than retail investors and we believe that a lower leverage limit will reduce investor choice.

NRF investors are also assisted by industry professionals who are required to do a suitability analysis. We believe that NRF investors who have the benefit of full, true and plain disclosure and the advice of registered advisors working in the investment dealer channel should enjoy access to a broad choice of investment strategies. Concerns that the CSA may have with respect to leverage should be addressed through enhanced disclosure. We agree with the additional Leverage Disclosure Requirement proposed by the CSA in the Phase 2- Second Stage.

Another point which we believe the CSA should consider for future revisions to National Instrument 81-106 is the calculation of the management expense ratio ("MER") as it applies to NRFs that employ borrowings. Currently the calculation of the MER requires the inclusion of interest expense which increases the MER. However, interest expense is not a management expense if the NRF is borrowing as part of the investment strategy to enhance income or returns. However, as NI 81-106 is currently drafted, the calculation of the MER that is disclosed in the Financial Highlights table does not consider that the borrowings employed as part of the investment strategy that generated the interest expense may have generated additional income (often income is well in excess of the interest expense) or returns that benefits investors of the NRF thereby reporting a confusing, one-sided calculation. We don't see how the current calculation assists investors or advisors in understanding how leverage is used in the NRF, and we believe it causes unnecessary confusion. We would propose that interest expense relating to investment activities and other similar financing costs be excluded from the calculation of MER as we believe that this would provide a better representation of the ongoing operating costs of a NRF.

Total Leverage Limit

9. ***Question:*** *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.*

Response: It is not unusual for NRFs to employ investment strategies that borrow cash to invest, hedge foreign currency or hedge other risks such as interest rate risk. Fixed income based investment strategies may use these three investment tools. The combination of these activities could cause the 3 times leverage limit to be exceeded, yet interest rate and currency hedging is intended to lower risk and we would be prevented from doing so. As a result, the 3 times limit effectively reduces the ability of a fund to hedge risks which would be detrimental to investors.

10. ***Question:*** *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: In the event that a leverage limit is implemented which includes derivatives then we believe that specified derivatives that are used for hedging should be excluded from the leverage calculation. These specified derivatives are not used to create leverage rather they are used to reduce certain risks. In addition, the proposed leverage calculation includes the aggregate notional amount of specified derivatives which does not consider the fact that notional amounts of

certain derivatives may partially offset each other, ie., the fund may enter in to a subsequent derivative position to offset an initial position due to changes in risk exposures; however, the leverage calculation would increase the aggregate notional amount and as a result the leverage even though derivative positions have been partially offset.

The current definition of "hedging" in NI81-102 adequately describes these types of transactions.

11. ***Question:*** *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.*

Response: As addressed in our response to question #10, we believe, at the very least, the notional amount of derivatives used for hedging should not be included in the total leverage calculation. Further, we do not believe that restricting the use of borrowings and leverage by NRFs is appropriate or necessary to ensure that the regulatory approach with respect to NRFs continues to adequately protect investors. We believe that additional disclosure would provide investors with a better understanding of the impact of the use of borrowings or short selling or derivatives and as a result make even more informed investment decisions. Such disclosure could include: (i) the sensitivity in changes to net asset value as a result of the use of borrowings or short selling or derivatives; and (ii) the identification of hedging related derivatives and an explanation of the risks and how such derivatives hedge those risks.

12. ***Question:*** *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.*

Response: Phase 2 – Second Stage proposes that, for both alternative funds and NRFs, to limit the mark-to-market exposure with any one counterparty to 10% of NAV. NRFs often use specified derivatives for hedging purposes and may hedge the currency risk up to 100% of the portfolio value. Funds may obtain better terms if the derivatives are entered into with one counterparty instead of separating them among various counterparties. If a Fund needs to terminate a derivative contract early due to its mark-to-market exposure being above the 10% limit and then to re-enter into the contract, it will then incur a cost due to the bid-ask spread. We understand that this limit is to counterbalance the exemption of NRF to be prohibited from entering into specified derivatives with counterparties that do not have a "designated rating" as defined in NI81-102. We suggest the 10% mark-to-market exposure limit with one counterparty exclude specified derivatives that are entered with a counterparty that has a "designated rating".

Transition

16. ***Question:*** *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.*

Response: We believe that grandfathering and continuation of exemptive relief should be granted to existing NRFs under Phase 2.

We believe that a 6-month transition period for existing NRFs is not appropriate as the proposed amendments are inconsistent with the investment decision made by investors and their legitimate expectations or the commercial decision made by the investment fund manager in launching the fund. Neither investors nor fund managers should be forced into paying for amendments that are inconsistent with the investment bargain that was entered into at the time of investment; and the costs and disruption associated with a requirement to transition could be significant for NRF managers and investors. Amending fund documents, obtaining securityholder approvals, if required, and the associated notice and continuous disclosure requirements would be extremely difficult. Many issues are also raised, for example, tax implications of realigning portfolios, impact on trading of NRF securities and the possibility that investors do not approve changes. The proposed borrowing limits would immediately impact two Brompton funds and cause the reduction of distributions and likely the trading price of such funds. The grandfathering of all existing NRFs will lead to the least confusion and inequity for investors and all other market participants. In addition, the existing NRFs should be able to continue to increase their assets through follow-on offerings so that the Funds can continue to improve liquidity for their investors and to lower or improve the management expense ratios.

We believe that changes proposed in Phase 2 – Second Stage will likely require securityholder meetings. Changes that generally require securityholder meetings include: (i) changes to the investment objectives; (ii) changes to the investment strategies or guidelines; and (iii) changes to the investment restrictions. The costs of securityholder meetings are estimated at $75,000 per NRF which would translate into approximately $150,000 in costs to be borne by Brompton's NRFs and indirectly investors.

Conclusion

Phase 2 – Second Stage, while reflecting certain comments and concerns submitted by market participants in 2013, will still have a negative impact on investors and on an industry which we believe has functioned very well under the current regulatory regime. The industry is a highly regulated and stable one. While different, there is nothing to suggest that their construction, distribution process, management, performance or regulatory framework are inferior to that in respect to mutual funds.

We believe that the NRF market is working well and the major investment dealers have a robust risk rating and approval process under which NRF offerings are reviewed. These offerings are reviewed by experienced market professionals with respect to disclosure, risk and suitability for investors. We understand that NRFs must undergo an underwriting committee process before a major investment dealer firm will support a public offering and specific terms such as leverage and the use of derivatives as well as disclosure concerning the NRFs ability to pay indicated distributions are carefully reviewed. We believe investment dealers and the investment fund managers who have prospectus liability and risk as to

reputation and relationships for these products have been effectively supervising and imposing key terms for the benefit of the market and investors.

We look forward to working with you on this initiative.

Yours truly,

//Signed// *"Mark A. Caranci"*
Mark A. Caranci
President & Chief Executive Officer

//Signed// *"Craig T. Kikuchi"*
Craig T. Kikuchi
Chief Financial Officer

December 22, 2016

British Columbia Securities Commission
Alberta Securities Commission
Financial and Consumer Affairs Authority of Saskatchewan
The Manitoba Securities Commission
Ontario Securities Commission
Autorité des marchés financiers
Financial and Consumer 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
Fax: 416-593-2318
Comments@osc.gov.on.ca

Dear Sirs/Mesdames:

Re: Canadian Securities Administrators ("CSA") Notice and Request for Comment dated September 22, 2016 - Modernization of Investment Fund Product Regulation – Alternative Funds ("the Proposed Amendments")

This comment letter is submitted on behalf of Sun Life Global Investments (Canada) Inc., a member of the Sun Life Financial group of companies, to provide our comments on the legislative amendments referred to above.

About Sun Life Financial

Sun Life Financial ("**SLF**") is one of Canada's largest financial services organizations. It provides life and health insurance products, asset management services and group benefits to over 37 million clients worldwide. As of September 30, 2016 it has over $164 billion in corporate assets and over $908 billion in assets under administration. The Sun Life Financial group of companies includes MFS Investment

Management, one of the largest investment management companies in the United States with over $578 billion under management as of September 30, 2016 and SLF is also a major participant in the institutional asset management space through Sun Life Investment Management[1] with over $51 billion under management. Sun Life Global Investments (Canada) Inc. ("**SLGI**" or "**We**") is one of Canada's fastest growing investment management companies with $15 billion in asset under management in 67 retail and 41 institutional funds as of September 30, 2016. In May of 2016 SLGI launched its first "commodity pool" under NI 81-104, the Sun Life Multi-Strategy Target Return Fund.

A. General Comments

We are providing these comments based upon our experience with NI 81-104 and our commodity pool, the Sun Life Multi-Strategy Target Return Fund. Therefore, our comments are primarily concerned with how the Proposed Amendments would affect "alternative funds". Although we recognize that many of our comments may also impact non-redeemable investment funds, we will not be commenting on those questions that solely relate to non-redeemable investment funds.

We wish to note that we are generally supportive of the Proposed Amendments, subject to our comments below.

B. Definition of "Alternative Fund"

CSA Questions

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 agree with the proposal to replace the term "commodity pool" with "alternative fund", and the rationale stated in the Proposed Amendments. In particular we believe the term "alternative fund" is broad enough to capture the variety of different investment strategies investment funds could be expected to take advantage of if the Proposed Amendments are enacted. In addition, we find the current term "commodity pool" to be an inaccurate and confusing term for the kinds of funds that are currently governed by NI 81-104. However, although this is not explicitly proposed in the Proposed Amendments, we are not in favour of referring to existing NI 81-102 mutual funds as "conventional

[1] The Sun Life Investment Management group of institutional investment management companies comprises Bentall Kennedy Group in North America, Prime Advisors, Inc. and Ryan Labs Asset Management Inc. in the United States, and Sun Life Institutional Investments (Canada) Inc. in Canada. These operations have combined third-party assets under management of $51.1 billion, as of September 30, 2016. Sun Life Investment Management is supported by the investment division of Sun Life Assurance Company of Canada that manages $146 billion in assets under management for the Sun Life Financial group of companies as of September 30, 2016.

mutual funds" and instead would prefer that they continue to be referred to as "mutual funds". We feel that using the term "conventional mutual funds" may stigmatize mutual funds in a negative way. We suggest that referring to the different kinds of investment funds to be governed by NI 81-102 as "mutual funds", "alternative funds" and "non-redeemable investment funds" is sufficient to differentiate them in the minds of investors.

C. Investment Restrictions

CSA Questions

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 do not have any comments on this question, however we are supportive of the comments made in response to this question in IFIC's comment letter

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 are supportive of the proposal to raise the concentration limit for alternative funds to 20%. However, we do not believe that a hard cap is necessary.

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.

We believe that alternative funds should have a higher limit for illiquid assets than mutual funds. We suggest that, similar to the proposed rule for the concentration limit, alternative funds be permitted to have the same illiquid asset limit as non-redeemable investment funds, a 20% limit at time of purchase with a 25% hard cap. Alternative funds are intended to have greater flexibility to pursue different investment strategies than mutual funds, and permitting a higher limit for illiquid assets would grant this flexibility, while also provide greater consistency within the rules between alternative funds and non-

redeemable investment funds.

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.

We do not have any specific comments on this question, however we are supportive of the comments made in response to this question in IFIC's comment letter.

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).

We do not have any comments on this question as it relates solely to non-redeemable investment funds, but note that it would match with our response to question 4, above.

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.

We do not have any comments on this question as it relates solely to non-redeemable investment funds.

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.

Generally, we do not believe that investors are well served through frequent and consistent borrowing for the purposes of generating investment returns outside of specific and limited cases, primarily concerning illiquid assets, such as investing in commercial real estate or infrastructure. In cases such as these, the ability to borrow on a long term basis for the purpose of providing an investment return might be suitable, however it is important that the risks are clearly disclosed to underlying investors.

In regards to the question concerning the source of cash borrowing, we would urge the CSA to consider a broader range of market participants as suitable lenders. We suggest that in addition to entities that meet the definition of section 6.2 in NI 81-102, the CSA also permit lenders to be entities that qualify as a sub-custodian for assets held outside of Canada in section 6.3 of NI 81-102. We would argue that broadening the available sources of lending in the market would likely lower the costs to the funds by increasing competition and likewise spread the counterparty risk among those market participants that are willing to participate. If the CSA determines that using the definition in section 6.3 to determine permitted lenders is unsuitable, we suggest that the criteria contained in section 6.3 can be narrowed geographically to those entities organized and regulated in countries of the European Economic Area, the G7 countries and Australia and New Zealand.

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.

While we applaud the goal of the CSA to improve investor protection from inappropriate levels of risk, we believe the proposed exposure limit of 3 times leverage, is too low and will restrict the ability of current and future alternative funds to achieve their objectives through the use of derivatives. In particular, we believe the proposed limit will negatively affect those alternative funds that use derivatives seeking to limit volatility or hedge against different types of risk. We do not believe using derivatives to gain exposure to certain asset classes inherently increases the risk of a fund since derivatives and their underlying assets can display similar return and risk characteristics. With proper risk controls in place, using derivatives to gain exposure can have certain benefits, as listed below, and therefore, alternative funds that use derivatives in this manner should not be penalized compared to those funds that use derivatives as a hedging tool in a traditional sense. Some of the benefits of using derivatives to gain exposure compared to the underlying assets are:

1. Derivatives may allow investment funds to gain exposures that the underlying assets cannot provide, for example replicating a bond index. As a result, these funds may provide better diversification than traditional balanced portfolios, especially during stressed market conditions when volatility of underlying assets, such as stocks and bonds, tends to go up simultaneously.
2. Derivatives may offer better liquidity than the underlying assets. Regulatory changes in the banking industry since the financial crisis have reduced the number and scale of market makers. Better liquidity provided by derivatives allows fund managers to increase and decrease exposure more quickly, which is critical for risk management purposes.
3. There are certain asset classes, such as foreign exchange, where the bulk of the market is derivatives based.

As a result of these benefits, we suggest that rather than imposing a single limit on the collective leverage exposure of cash borrowing, short-selling and derivatives, the CSA considers taking a broader approach to managing risk by allowing alternative funds to manage and disclose their risk by using rules similar to the Value at Risk ("VaR") model found in the European UCITS Framework. The UCITS Framework is the Guidelines on Risk Measurement and the Calculation of Global Exposure and

Counterparty Risk for UCITS of the European Securities and Markets Authority and the VaR approach is a measure of the maximum potential loss that an investment portfolio may suffer due to market risk, rather than the use of leverage. More specifically, the VaR approach measures the maximum potential loss at a given confidence level, or probability, over a specific time period under normal market conditions. For example, if the VaR (based on a one month, 99% confidence level) of a fund equals $4 million, this means that, under normal market conditions, there is a 1% probability that the value of the Fund's portfolio could decrease by $4 million or more during one month. Under the VaR Model as prescribed by the UCITS Framework, a fund's VaR cannot be greater than 20% of the fund's NAV irrespective of the portfolio assets held in the Fund and the amount of leverage employed by the Fund Additional controls can also be placed on this approach, such as requiring back testing to further strengthen the risk management process. By assessing risk based upon the potential loss of the portfolio without consideration of the underlying assets, the VaR method would allow alternative funds the flexibility to invest in different types of assets, including derivatives, in a way that best assists them in achieving its investment objectives, without exposing the alternative fund to too much risk.

We suggest that without the flexibility to deploy derivatives using the VaR model, there may be unintended negative impacts to investors of alternative funds. These unintended consequences may include alternative funds increasing the concentration of assets in long-only strategies that are increasingly susceptible to market volatility, and therefore may be more susceptible to suffering negative total returns.

It is for the reasons above, we believe that the proposed restriction of 300% leverage is too restrictive, and this limit combined with the manner in which it is calculated, may reduce innovation in the alternative fund market and may prevent investors from achieving their desired investment outcomes. Instead, as mentioned above, we suggest that utilizing VaR based risk controls instead of having a hard limit on leverage would be a better approach. However, despite suggesting that a VaR based risk management approach be adopted, we do not believe the sum of notionals concept needs to be eliminated entirely. We agree that the sum of notionals concept is relatively simple to understand, therefore we suggest that instead of representing a hard limit on total leverage, the CSA require alternative funds to disclose, based on a sum of notionals calculation, the maximum *expected* total leverage exposure (cash borrowing, short-selling and derivatives) an investment fund manager intends for an alternative fund. Under this approach the sum of notionals calculation would not constitute a limit on leverage exposure, instead it would disclose to investors the manager's expectations regarding leverage. The CSA could consider including a requirement that the manager not exceed the disclosed level of leverage in the normal course of management, and higher levels of leverage, if they occur, would only occur for short periods of time.

We believe that the sum of notionals disclosure coupled with the VaR disclosure would adequately inform investors of the levels of risk and overall leverage an alternative fund would be exposed to, while the VaR method would force investment fund managers to limit risk exposure across all asset classes in their alternative 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?

We do not believe that the sum of notionals calculation, as proposed under the Proposed Amendments, accurately reflects the risk exposure to a fund, and as we describe elsewhere in this letter, is likely counterproductive in informing investors of the actual levels of risk funds are exposed to by the use of leverage. If the CSA wishes to have a total leveraged exposure limit similar to the Proposed Amendments, we strongly believe that in order to better disclose the true levels of risk exposure due to leverage, the calculation should permit offsetting and exclude specified derivatives for hedging purposes. Not only are these transactions intended to reduce a fund's overall risk exposure, but keeping the calculation as it is currently proposed, creates an inconsistency between mutual funds and alternative funds. This inconsistency will arise because mutual funds are permitted unlimited hedging exposure, but alternative funds (which are supposed to be permitted greater access to derivatives) would be constrained in using hedging transactions as a result of the leverage calculation.

Our comments in response to questions 9 and 11 are applicable here as well.

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 CSA that the sum of notionals calculation for derivatives may not be an appropriate measure of risk. Indeed, depending on the circumstances it may well be unhelpful or even misleading to clients as to the true level of risk they are employing in their investments.

We do not believe that a single methodology presently exists that accurately explains fund leverage, and therefore any purely prescriptive approach will unfairly penalize some investment strategies over others. We support the CSA in seeking to highlight to clients where and when leverage is being used and particularly where it can magnify the risks of an investment. However, we believe that the term leverage needs to be clarified. As mentioned in the Proposed Amendments, leverage can be achieved through the use of borrowing cash to reinvest, short selling or via the use of derivatives. We support the proposed cash borrowing and short selling limits as well as the creation of a combined cash borrowing and short selling limit. However, we do not support the creation of a single limit on the total leveraged exposure for alternative funds. We believe that the risks represented by derivatives are distinct enough from cash borrowing and short selling to require a different approach.

We agree that the use of 'leverage' through derivatives should be clearly disclosed to investors and that suitable controls should be in place to measure, monitor and control the use of these financial

instruments. When using derivatives, we believe that the establishment of a Risk Management Process ("RMP") is a vital component of controlling the risks and that the RMP should clearly state the mechanisms through which the controls operate, including a clearly stated and explained methodology for calculating leverage achieved through derivatives.

In addressing the question raised in the Proposed Amendments as to where a sum of notionals calculation is less suitable to measuring the risks involved in derivatives, we believe that, the current proposal unfairly penalizes fixed income and FX based derivatives relative to equities based derivatives. For example, on the basis of the proposed sum of notionals calculation a $1million of equity notional has the same leverage as $1million of fixed income or FX notional irrespective of the levels of volatility and risk. In many cases, the risk of fixed income derivatives can be substantially lower than the equivalent level of equities based derivatives based on the inherent risks of the underlying assets. In addition, as noted in the proposal, derivatives can also be sensitive to other factors such as changes in interest rates and foreign exchange rates. These different kinds of derivatives each carry a different exposure to risk, however as previously mentioned, the "sum of notionals" approach will treat them all as the same. As a result, we feel that the approach in the Proposed Amendment may unfairly generate an expectation that the level of risk is the same to the end client regardless of the type of derivative used.

Due to the issues with the assumption of equal risk between different types of derivatives, we suggest that instead of having a limit on total leverage, that a suitable alternative would be to require that alternative funds measure and provide disclosure for broader market risk (including derivatives) using a system similar to the European UCITS Framework and the parameters contained therein to measure a fund's VaR. We suggest that this alternative approach would take into account the risks to an alternative fund's underlying investments from a market risk perspective and while at the same time would grant greater flexibility for the use of derivatives when compared to the total leverage limit found in the Proposed Amendment. At the same time we feel that requiring an alternative fund to disclose its VaR, how it is calculated, and an explanation of the UCITs Framework approach would provide clearer public disclosure to investors on the risks associated with the fund's derivatives and broader exposure to leverage. The UCITS Framework and the VaR model are discussed in greater detail in our response to question 9.

As part of the disclosure concerning the UCITS Framework and VaR, we are supportive of being transparent in disclosing a fund's overall exposure to derivatives. Therefore we suggest that a practical example of how each derivative instrument in the portfolio is being handled should be disclosed in the prospectus for investors to review. Although we feel that the approach described above (UCITS Framework and a practical example) provides clearer disclosure of the leverage of the calculation to the investors in an alternative fund, we understand that this could make it difficult for funds to be compared between providers with different approaches. Therefore, as we mention in our response to Question 9, in addition to requiring disclosure we proposed above, we suggest keeping the "sum of notionals" calculation in the Proposed Amendments representing the investment fund manager's *expected* maximum leverage exposure for the alternative fund, instead of a hard limit for total leverage. Finally, in addition to providing clearer disclosure to investors of the leverage and derivative risks facing an alternative fund, we believe that if our suggested alternative is adopted, complying with these requirements will force managers who wish to offer alternative funds to invest in more sophisticated risk control procedures and compliance oversight, which in turn will provide greater protection for investors.

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.

We do not have any comments on this question as it relates solely to non-redeemable investment funds

D. Disclosure

CSA Questions

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.

As alternative funds are expected to have greater exposure to derivatives and leverage than conventional mutual funds or ETFs, in connection with our earlier suggestion regarding the adoption of a VaR and a sum of notionals calculation representing maximum expected leverage, we suggest that the Fund Facts for alternative funds include a text box permitting a brief description of the expected maximum levels of leverage or types of derivatives expected or permitted within that alternative fund.

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?

We do not have any comments on this question, however we are supportive of the comments made in response to this question in IFIC's comment letter.

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.

We do not have any comments on this question, however we are supportive of the comments made in response to this question in IFIC's comment letter.

E. Transition

CSA Questions

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 period required to adjust to the changes will be determined by the final implemented changes and we would encourage the CSA to allow for sufficient time to be provided to allow for the this transition. Specifically, we believe a transition period of at least a year following the publication of final rules would provide sufficient time for existing alternative funds to revise their disclosure documents as necessary within their usual renewal schedule and apply for any necessary relief for any current permitted activities that will be prohibited following implementation.

Conclusion

Thank you for this opportunity to comment on the Proposed Amendments. If you would like to discuss these matters further or have any questions please contact me at 416-979-6496 or at neil.blue@sunlife.com

Sincerely,

Neil Blue

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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 published for comment September 22, 2016

We are lawyers in the Investment Management practice group of Borden Ladner Gervais LLP and we work with many fund managers and their investment funds (mutual funds, closed-end funds and ETFs) that are regulated by National Instrument 81-102 *Investment Funds* (NI 81-102), as well as with fund managers and their commodity pools that are now regulated by NI 81-102 and National Instrument 81-104 *Commodity Pools* (NI 81-104). We also act for many fund managers and their investment funds that today are not regulated by NI 81-102, because those fund managers have chosen not to qualify their securities for sale to the public, given the restrictions that would apply to them under NI 81-102 if they chose to do so. Many of those fund managers did not wish to take advantage of NI 81-104 for various reasons, including the fact that there are significant distribution challenges and rather onerous consequences of being considered a "commodity pool" under that instrument.

We have closely followed and commented on the numerous changes to NI 81-102 that have been proposed and implemented in the past number of years, and have strongly supported the CSA in its efforts to develop an alternative funds regime.

We note that our lawyers participated in various working groups of industry associations to assist them in developing their comment letters. Michael Burns is the Chair of the Alternative Investment Management Association (AIMA) and provided input into our letter, as well as into the AIMA letter. We also participated in the working groups and reviewed the comment letters of The Investment Funds Institute of Canada and the Portfolio Management Association of Canada while finalizing our letter.

We are pleased to provide our views on the most recent proposals for amendments to NI 81-102 and the related instruments, and support the concepts behind the proposed alternative funds regime. Our comments highlight some amendments that we consider should be made for clarity and/or to allow for practical adoption and implementation of the regime by industry participants, so as to achieve the objectives of the CSA, which we understand to be enhancing investment opportunities for investors by allowing for access to liquid alternative investment asset classes and strategies. In our view, the proposed alternative funds regime will provide Canadian retail investors with access to more innovative investment strategies, which are still appropriate from a risk perspective, while also providing them with useful disclosure that is suited to the specific type of investment vehicle.

We greatly appreciate the practice of the CSA over the past few years to publish blacklined copies of the instruments being amended. This significantly enhances our ability to grasp the significance of what is being proposed and allows us to more easily provide comments to the CSA.

Our comments should not be taken as the views of BLG, other lawyers at BLG or our clients.

We provide our comments in the order of the various instruments, and their provisions, that were published for comments. We have chosen to answer certain of the CSA's questions where we feel we have particular expertise and experience.

Comments on NI 81-102 Amendments

1. Commentary on division of NI 81-102 into rules relating to "alternative funds", mutual funds and non-redeemable investment funds

Overall we agree with the proposals of the CSA to divide the world of publicly offered investment funds into these broad categories, although we note that there are a number of different sub-sets of these categories, each with slightly different requirements and some of which are overlapping. We recommend that the CSA consider a discussion in the Companion Policy about these categories and the implications of being one or the other. Please see also our comments below on the definition of "non-redeemable investment fund".

We prepared for our clients a table indicating the various requirements that will apply to each type of investment fund, if the amendments are adopted, which may serve as a useful format for the Companion Policy. Our Investment Management Bulletin accompanies this letter.

2. Part 1 – section 1.1 - Definition of "alternative fund"

In answer to the CSA's first question about replacing the term "commodity pool", with "alternative fund", we strongly agree that the term "commodity pool" is a misnomer and is not readily understandable by investors, whereas "alternative fund" is more comprehensible and plainly stated.

As currently drafted in the proposed amendments to NI 81-102, it is the fundamental investment objective of the mutual fund that determines whether a mutual fund is an alternative fund, by either allowing for investment in asset classes or by the adoption of investment strategies that would not otherwise be permissible. However, in many cases, it is the investment *strategies* of a fund, and not the investment objective, per se, that makes a mutual fund an alternative fund. Accordingly, the definition of "alternative fund" should be revised to make it clear that an alternative fund is a mutual fund that has adopted either fundamental investment objectives or investment strategies that permit it to invest in asset classes or financial instruments in a manner that is otherwise prohibited by Part 2 of NI 81-102, but for prescribed exemptions. If the CSA consider that the

definition works as drafted, then we recommend that further discussion of this point be included in the Companion Policy to NI 81-102 so as to alleviate any confusion.

We also note from the CSA's commentary in the response to comments and generally in the CSA notice that there is no intention (at present) for the CSA to implement required naming conventions for alternative funds; for example, by requiring the fund names to highlight that the funds are "alternative funds". We agree with this approach. However, we strongly recommend that the CSA commentary in the response to comments be included in section 2.01 of the Companion Policy of NI 81-102 for future clarity and on-going understanding, given that CSA statements in Notices become increasingly difficult to find in years following a rule's adoption.

We point out that the CSA may wish to discourage future conventional mutual funds from using the word "alternative" in their names and in the description of their investment strategies. We are not aware that this practice is wide-spread, but we consider that this is a point that the CSA may wish to make in the Companion Policy, so as to avoid any uncertainty in the minds of investors (and their advisors) as to the status of the particular fund. Any conventional mutual fund that currently has the word "alternative" in its name may wish to consider changing or supplementing its name to ensure clarity. This name change should not require a securityholder vote and should not be considered to be a material change; we recommend that the CSA emphasize this point.

We also recommend that the CSA add a brief paragraph to section 2.01 of the Companion Policy clarifying that it is not intended that all "precious metals funds" are alternative funds; that is, simply because precious metals funds invest in one or more precious metals does not mean that they fall within the definition of alternative fund. There has to be more to the fund than simply investing in precious metals. It would be helpful to clarify that an alternative fund *could* include a fund that invests in precious metals provided there are other investment objectives and/or strategies followed by that fund that brought it within the alternative fund world.

Related to our comments on the "alternative funds" definition, we have considered the CSA's second question – namely whether there are particular asset classes common under typical alternative investment strategies, but have not been contemplated for alternative funds under the amendments.

We understand that many in the industry would like the CSA to move towards a better recognition of the place that "market neutral" strategies have in an investing strategy for investors.

The investment objective of a market neutral strategy is to remove market risk (i.e. the risks of significant swings in the market) by balancing long and short positions in an effort to provide returns in all market conditions. A market neutral strategy can provide true diversification in an investment portfolio, as it is intended to be uncorrelated to the market. However, in order to employ a market neutral strategy, a fund must be permitted to have short and long positions of up to 100% of net asset value (NAV). Given the maximum short position limit of 50% of NAV suggested for alternative funds in section

2.6.1(c)(v) of NI 81-102, it will be difficult for a pure market neutral investment strategy to be offered as an alternative fund under this instrument.

Although it may be technically possible for an alternative fund to replicate a market neutral strategy under the proposed amendments through the use of short-selling and specified derivatives, such an approach would be inefficient and more costly to implement.

We submit that market neutral strategies can play an important role in removing market risk in an investor's portfolio and should be permissible as an alternative fund under NI 81-102. An exemption could be made to the proposed 50% of NAV short sale limit for funds that hold themselves out as market neutral. This would permit such a fund to have short positions up to 100% of NAV.

3. Part 1 – section 1.1 - Definition of "cleared specified derivative"

The definition of "cleared specified derivative" does not distinguish between two of the principal participants in the derivatives industry: the futures commission merchants that execute and clear exchange-traded derivatives and the clearing corporations that clear over-the-counter derivative transactions. While the blurring of these distinct functions may currently work as drafted, we submit that as new derivative rules continue to be refined and to come into effect in Canada, it will be necessary to distinguish between exchange-traded derivatives and cleared derivatives under NI 81-102. We suggest that the definition of cleared specified derivative be split into two definitions, as follows:

(a) "cleared specified derivative" means a specified derivative that is cleared through a regulated clearing agency

(b) "exchange-traded specified derivative" means a specified derivative that trades on a futures exchange or an options exchange and that is executed and cleared through a dealer that is registered or exempt from registration under the laws of the jurisdiction of the mutual fund.

4. Definition of "non-redeemable investment fund"

We strongly recommend that the CSA take the discussion about what is (and is not) a non-redeemable investment fund that is presently found in NI 81-106 and its Companion Policy and include it in NI 81-102 and its Companion Policy, so that this instrument can be an all-encompassing instrument and a "one-stop" shop for understanding the CSA's division of the public fund universe. Some participants do not think to look to the Companion Policy of NI 81-106, and we feel that the industry and their advisers, alike, will benefit from this amendment. We recognize that NI 81-106 also needs to have this discussion, given that it applies to public and private issuers and the latter issuers need to understand if they are "investment funds" or not.

We also recommend that the CSA consider updating the NI 81-106 Companion Policy discussion, particularly as it relates to clarifying the recent thinking about what investment vehicles the CSA considers NOT to be an investment fund, which has been

subject of some consternation within the industry and the legal community, and, in our view, deserves public consultation. Some of the discussion that is in section 1.3 of the Companion Policy to NI 31-103 and CSA Staff Notice 81-722, for instance, as it relates to private equity and venture funds, as well as mortgage investment entities, could be usefully incorporated into the Companion Policy to NI 81-102 (and NI 81-106, if the discussion is duplicated), to clarify that these funds (if publicly offered) are not considered to be investment funds and are not subject to the rules of NI 81-102. This area (that is, what is and what is not an investment fund) is generally poorly understood; we would be very pleased to discuss this issue further with CSA staff.

5. Section 2.3

In our view, subsection (4) does not work as the CSA appear to intend or if it does, it's a somewhat meaningless exclusion in our view. We understand the "look through" test in subsection (3), but we believe that a top fund should be able to exclude an investment by ANY investment fund (not just an IPU or a stock or bond index) that the top fund invests in, if that investment represents less than 10 percent of the NAV of that underlying fund. In our view, it does not make sense to restrict subsection (4) to underlying IPU investments or stock or bond indices.

6. Section 2.4

We note the CSA's intention to consider further rules, including risk management techniques relating to liquidity risk management for investment funds, which is mentioned in the CSA Notice and Request for Comment and would welcome the opportunity to provide input into this discussion at an appropriate time. We consider that there is a real need for further clarity and thought on this issue. In our view, this topic and the scope of the definition of illiquid assets deserves further commentary and consultation not necessarily tied to the alternative funds proposals.

7. Section 2.6

As a drafting matter, subsection (1) should be made subject to subsection (2) for alternative funds and non-redeemable investment funds. In addition, subsection (2) should clarify that an alternative fund and a non-redeemable investment fund may grant security interests over any of their portfolio assets in connection with borrowings that are permitted under this subsection. This is specifically permitted under subsection (1), but not subsection (2), which it should be.

More substantively, we consider that borrowing from a related party is not such an insurmountable conflict of interest – it is certainly not otherwise prohibited - that this practice deserves IRC "approval", as opposed to a positive recommendation. We note that many in the fund industry enter into related party agreements, such as portfolio management or other services provision, where IRC "approvals" are not contemplated. We do not view a borrowing arrangement to be materially different from these other related party services agreements.

In our view, subparagraphs (a) and (b) of subsection (2) should be drafted with the following changes for clarity and consistency:

(a) The alternative fund or non-redeemable investment fund ~~may only~~ borrows from an entity described in section 6.2 and section 6.3 [see further below]

(b) If the lender is an affiliate [or associate? – *see further page 8174 of the OSC Bulletin edition of the CSA Notice – Section 6 of the amendments to NI 81-101 refers to "associates"*] of the investment fund manager of the alternative fund or non-redeemable investment fund, the independent review committee of the alternative fund or non-redeemable investment fund must provide a positive recommendation to proceed with ~~has approved must approve~~ the applicable borrowing agreement after such proposed lending arrangement has been referred to the IRC under subsection 5.1 of NI 81-107.

We also urge the CSA to permit alternative funds to borrow from non-Canadian lenders, which we understand is a common practice for alternative funds so as to allow for more efficiencies relating to loans in foreign currencies to allow for transactions in those foreign currencies.

8. Section 2.6.1

Please see our references to market neutral funds in connection with our comments on the definition of "alternative funds" in comment 2 above. This section should be modified to permit these strategies.

We also consider that there is a need to exclude government securities and IPUs from the single issuer "short selling" limits provided for in paragraph 2.6.1 (1)(c)(ii) and (iv). This exclusion is just as relevant for short selling as it is for long positions and should apply to all types of investment funds in this context, as it does for long positions.

9. Section 2.6.2

Please see our references to market neutral funds in connection with our comments on the definition of "alternative funds" in comment 2 above. This section should be modified to permit these strategies.

10. Section 2.7(4) (5)

We consider that alternative funds and non-redeemable investment funds should be exempt from these provisions (counterparty exposure).

It is not clear to us that there is any risk from exposure to a single counterparty that needs to be mitigated. 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 is commonly required under most derivative transactions and rules are currently being drafted and implemented that will make the posting of collateral mandatory under most over-the-counter derivative transactions.

11. Section 2.9.1

We agree that it is important for an investor to understand the amount of leverage in the portfolio of an alternative fund or a non-redeemable investment fund. For this reason, the leverage calculation should be as simple as possible. While a leverage calculation based on the aggregate notional amount of an investment fund's specified derivatives position may be simple to understand, we submit that this calculation results in a distorted view of the fund's actual exposure under its derivatives positions. In most cases, a fund's liability under its derivatives positions is significantly less than the notional amount of those derivatives. In addition, if a leverage limit is imposed on these investment funds to mitigate risk, then specified derivatives that are entered into for offsetting hedging purposes in order to reduce a risk in the portfolio should not be included in the leverage calculation. In order to not unduly restrict the investment strategies of these funds, we submit that it would be more appropriate to only require disclosure of the leverage ratio of the funds, and not to impose a limit on the amount of permitted leverage. As you know this is the manner in which leverage is presently dealt with under NI 81-104.

As we note above, there are no limitations on the aggregate notional exposure under specified derivative transactions under the current regime applicable to commodity pools. Similarly, there are existing closed-end funds that have strategies that do not comply with the proposed 50% combined borrowing and short sale restrictions. As the investment objectives and strategies of any existing funds were established to comply with the current regime, we recommend that existing commodity pools and closed-end funds be grandfathered in and permitted to continue to operate under an exemption from any leverage limits (if any are adopted) subject to complying with the other requirements applicable to alternative funds and non-redeemable investment funds (as the case may be) under NI 81-102. We submit that, in many cases, to require existing commodity pools and closed-end funds to reduce the level of leverage used will result in the investment strategies used by the fund becoming wholly ineffective and may require such funds to cease operations.

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. 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. We believe that the approach adopted under the proposed amendments

would allow alternative funds to use these industry standard calculation methods for the purposes of calculating the fund's exposure under the proposed amendments. As set out in the proposed Companion Policy 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.

12. Section 6.8.1

Section 6.8.1 of NI 81-102 currently permits a fund to deposit up to 10% of NAV with a borrowing agent, other than its custodian or sub-custodian, as security in connection with a short sale (the "10% of NAV Limit"). In practice, a borrowing agent generally requires that the proceeds from the short sale, plus additional collateral be held as security. Under the current NI 81-102 aggregate short sale restriction of 20% of a fund's NAV, this practice results in the need for at up to two or three dealers/borrowing agents to facilitate and permit a fund to short the maximum 20% of its NAV.

However, given that the proposed amendments will permit an alternative fund to short up to 50% of its NAV, changes in the custodial provisions set out in Section 6.8.1 are necessary to alleviate both practical and operational issues for alternative funds. For example, under margin rules established by IIROC, an alternative fund entering into a short sale transaction for an equity security eligible for reduced margin would be required to post 130% of the market value of the short position as margin (security). As a result, an alternative fund that wishes to take full advantage of the increased short sale limits (50% of NAV) would be required to deal with 7 separate borrowing agents (other than the custodian) in order to comply with the 10% of NAV Limit in section 6.8.1. A similar situation would be experienced for other asset classes such as fixed income and FX forward transactions. This would not be practically feasible and would lead to operational and administrative inefficiencies and significantly increased costs for alternative funds.

We submit that a 20% of NAV deposit limit with borrowing agents (other than the fund's custodian or sub-custodian) as security for short sales by alternative funds would provide alternative funds with the flexibility to engage the services of two or more prime brokers (other than their custodian or sub-custodian) in an effort to execute their investment strategies in a more efficient manner and to help alleviate potential counterparty risk.

13. Parts 9 and 10

There is a need for Parts 9 and 10 to recognize that many alternative funds will allow purchases and redemptions on a weekly or monthly basis (that is, at the NAV of the Fund determined on the last day of a calendar week or month, for instance, provided the purchase order is received in advance of that applicable day). We point out that section 14.2(3) of National Instrument 81-106 Investment Fund Continuous Disclosure (NI 81-106) allows for weekly NAV calculations, but requires investment funds that use specified derivatives or engage in short sales to calculate NAV daily. Under the rules in Parts 9 and 10 of NI 81-102, the purchase or redemption price of a mutual fund security must be the next NAV determined after receipt of the applicable order. If a mutual fund is required to calculate NAV daily (as would be the case for many alternative funds), this

would create difficulties for funds redeemable on a weekly or monthly basis. We do not consider that new subsection 10.3(5) provides sufficient flexibility in this regard (this provision is intended to allow for additional – and different flexibility regarding payment out of redemption proceeds) and note that there is no such flexibility provided for in Part 9 (dealing with purchases).

We believe there is a simple drafting fix for both Parts 9 and 10:

> Despite subsection [insert the correct section reference] an alternative fund may implement a policy that a person or company making a purchase/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 purchase/redemption date of the alternative fund** ~~**first or 2nd business day**~~ after the date of receipt by the alternative fund of the purchase/redemption order.

We suggest that the CSA consider linking the weekly/daily NAV calculation requirements in NI 81-106 to the Companion Policy discussion about purchases and redemption orders and NAV for those purposes in NI 81-102.

14. Part 15

Section 15.6(1)(a) contains a prohibition against the inclusion of performance data in a 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 privately offered mutual fund (a pooled fund) with a suitable strategy that wanted to convert the pooled fund into a publicly offered alternative fund by filing a prospectus would not be able to include the historical track record of the pooled fund in sales communications pertaining to the alternative fund.

Given the unique nature of the proposed alternative fund changes, we strongly recommend that the CSA consider providing 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, particularly in the situation where the pooled fund complied with the new NI 81-102 regime in all material respects. Without this information, investors will not be able to obtain a full picture of the skill and abilities of the investment fund manager in carrying out the strategies of the specific fund. We consider this important information for investors and believe that appropriate caveats can be provided, that would allow investors to properly understand this information.

Comments on Fund Facts/Prospectus Disclosure – NI 81-101 and NI 41-101 Amendments

15. Under the proposed amendments, alternative funds will be required to include specified "text box" disclosure in Fund Facts or on the prospectus face page (as applicable) that, among other things, will require an explanation about the "specific strategies that differentiate this fund from conventional mutual funds" and "how the listed investment strategies may affect an investor's chance of losing money on their investment in the fund". We feel this text box disclosure is not necessary and could likely require lengthy explanations which will be at odds with the regulatory purpose of the Fund Facts/face page disclosure.

    We strongly recommend that the only relevant information (which may not even be that relevant given the other disclosure that will be in the Fund Facts or the long form prospectus), is a simple statement that "this mutual fund is an alternative fund. It has the ability to invest in asset classes or use investment strategies that are not permitted for conventional mutual funds. Please read the details of this fund's investment objectives and strategies carefully and ask your advisor for more information as to how this fund will help you achieve your investment goals".

    Anything else would be too long, duplicative and potentially meaningless for investors – particularly in a Fund Facts document or face page disclosure that is designed to be concise and simple.

    We particularly take issue with the notion that alternative funds' strategies may "affect investors' chance of losing money on their investment in the alternative fund". This type of dire warning was included in "commodity pool" prospectuses, but the effectiveness of this disclosure, when considered in the context of modern-day alternative funds and the Fund Facts/ prospectus disclosure is not appropriate. We note also that requiring this disclosure for alternative funds but not more generally to non-redeemable investment funds appears to suggest that somehow alternative funds will be more likely to "lose money", whereas non-redeemable investment funds are not. Also, it suggests that alternative funds are inherently more risky than conventional funds or closed-end funds, when this is not necessarily the case. We do not consider this distinction to be appropriate.

Comments on Transition

16. The CSA propose that any new rules will come into effect three months after publication date for the final rules, and that a further six months be provided to allow existing funds to change their affairs so as to comply with the new rules. We are not entirely certain that the suggested transition of the CSA works or is really necessary.

(a) **Some form of "grandfathering" will be necessary for existing commodity pools and closed-end funds as we recommend in our comment 11.**

(b) Otherwise, since there are not many commodity pools in existence, we recommend that the CSA simply permit existing commodity pools to continue with their prospectuses and operations – and make all amendments to their strategies (as required) and disclosure at their next renewal date, so long as that date is not within the 3 month transition period. Some timing considerations by the CSA would be considered very useful for existing commodity pools (i.e. allowing them to operate under the "old" regime until their next renewal time). It is not optimal for funds to have to file amended documents (which would be completely different – i.e. moving from a "long form" prospectus to the NI 81-101 requirements) mid-year or before the next renewal.

(c) The above-noted transition should also apply to closed-end funds that already have a prospectus and are reporting issuers (assuming they are in continuous distribution).

(d) Commodity pools and closed-end funds that do not wish to comply with the new regime, should be given a sufficient period to continue their operations, so long as no new sales are permitted after the lapse of one year (for instance) after the effective date of the new rules, so as to allow for an orderly wind-down of their operations or taking these vehicles private.

(e) Any current "private" fund that wishes to become a public reporting issuer (alternative fund) should be required to comply with the new requirements (i.e. change their affairs to become compliant) and file a preliminary prospectus under NI 81-101, which they can do at any time after the rules become effective.

(f) If any publicly offered mutual fund wishes to become an "alternative" fund, it will be required to adopt different investment strategies (and potentially investment objectives), which may take some time to implement. It would be appropriate for those funds to file an amended and restated prospectus with full compliance with the new requirements, if they wish to become an "alternative fund" before their next renewal.

Comments on Risk Classification Challenges

We understand that there will be challenges for alternative funds to comply with the new risk classification rules that were published in final form on December 8, 2016 and urge the CSA to consult further with the industry on this point. It may be that these amendments to NI 81-102 should include revisions to the risk classification rules to allow alternative funds to be able to calculate and disclose risk.

We thank you for considering our comments. Please contact any of the undersigned if you would like additional information or wish us to elaborate on our comments. We, together with others at our firm who have considered the proposed amendments, would be very pleased to meet with you.

Yours very truly,

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INVESTMENT MANAGEMENT BULLETIN OCTOBER 2016

Borden Ladner Gervais

CANADIAN REGULATORS UNVEIL DRAFT RULES TO PERMIT THE OFFERING OF ALTERNATIVE FUNDS TO RETAIL INVESTORS

The Canadian Securities Administrators (CSA) has ushered in a bold new era for Canadian investors in its final push to modernize the regulation of investment funds. On September 22, 2016, the CSA published proposed amendments to National Instrument 81-102 *Investment Funds* (NI 81-102), Companion Policy 81-102CP and related national instruments [available here] which, when adopted in final form, will permit alternative mutual funds to be offered to retail investors in Canada in much the same manner as conventional mutual funds are currently offered. With these rule amendments, the CSA are finalizing their investment fund modernization rule review project that was launched in 2010 and described in some detail in 2011[1].

The ultimate effect of the proposed amendments will be to bring conventional mutual funds, "alternative funds" and closed-end funds (non-redeemable investment funds) under the same regulatory umbrella, with much the same regulation, but with important and significant differences, especially as it applies to investment restrictions for each of these categories of funds.

The proposed amendments will provide managers with a promising opportunity to bring alternative fund strategies to retail investors and include some positive changes for conventional mutual funds, including exchange traded funds (ETFs), but may also present new challenges to some closed-end funds (non-redeemable investment funds), given the proposal to add new investment restrictions to these funds.

The comment period on the proposed amendments ends on December 22, 2016.

[1] Please see: ***Canadian Regulators Propose to Modernize Investment Fund Regulation*** Investment Management Bulletin Borden Ladner Gervais LLP June 2011 and *Moving Beyond Mutual Funds – New Proposed Regulations for Public Closed-end Funds and "Alternative" Funds* Investment Management Bulletin Borden Ladner Gervais LLP April 2013.

REVISED NI 81-102 INVESTMENT RESTRICTIONS – *AT A GLANCE*

Investment Restriction*	**Alternative funds**	**Conventional mutual funds and ETFs (mutual funds)**	**Closed end funds (Non-redeemable investment funds)**
Proposed changes are indicated in bold italic type			
Concentration Restriction	***20 percent of NAV, subject to carve-outs***	10 percent of NAV, subject to carve-outs	***20 percent of NAV, subject to carve-outs***
Control restriction	No more than 10 percent of votes / equity securities of an issuer		
Restrictions on types of investments	No investment in: • real property • mortgages other than guaranteed mortgages • loan syndications / participations if any responsibility for administering the loan	No investment in: • real property • mortgages other than guaranteed mortgages • ***commodities other than 10 percent in certain precious metals (waived for precious metals funds)*** • loan syndications / participations if any responsibility for administering the loan	***No investment in:*** • ***real property*** • ***mortgages other than guaranteed mortgages*** • ***loan syndications / participations if any responsibility for administering the loan***
Illiquid assets	10 percent of NAV at time of investment (hard cap of 15 percent)		***20 percent of NAV at time of investment (hard cap of 25 percent)***
Fund-of-fund investments	• ***100 percent in underlying alternative mutual funds, non-redeemable investment funds, conventional mutual funds and ETFs***	• ***10 percent in underlying alternative funds and non-redeemable investment funds*** • ***100 percent in underlying conventional mutual funds and ETFs***	• ***100 percent in underlying alternative funds*** • 100 percent in underlying non-redeemable investment funds, conventional mutual funds and ETFs
Borrowing	***Limited to 50 percent of NAV, subject to restrictions***	Limited to 5 percent of NAV, subject to restrictions	***Limited to 50 percent of NAV, subject to restrictions***
Short-selling	***Up to 50 percent of NAV, with single issuer limited to 10 percent of NAV; no cash cover required***	Up to 20 percent of NAV, with single issuer limited to 5 percent of NAV; 150 percent cash cover required in all cases	***Up to 50 percent of NAV, with single issuer limited to 10 percent of NAV; no cash cover required***
Total borrowing and short-selling	***Aggregate limit of 50 percent of NAV at all times***	N/A	***Aggregate limit of 50 percent of NAV at all times***
Derivatives for hedging and non-hedging purposes	• ***No designated rating requirements for the derivative or counterparty*** • ***Counterparty exposure limit of 10 percent of NAV for derivatives, other than for cleared specified derivatives***	• Designated rating requirements for the derivative or counterparty • Counterparty exposure limit of 10 percent of NAV	• ***No designated rating requirements for the derivative or counterparty*** • ***Counterparty exposure limit of 10 percent of NAV for derivatives, other than for cleared specified derivatives***
Derivatives for non-hedging purposes	Exempt	Cover required for specified derivatives transactions	Exempt
Leverage	***Cannot exceed 3x NAV***	Leverage prohibited	***Cannot exceed 3x NAV***
Securities lending, repurchase and reverse repurchase arrangements	Permitted, subject to conditions		

INVESTMENT RESTRICTIONS

The CSA propose to replace the term "commodity pool" with the term "alternative fund", which will be defined in NI 81-102 as "*a mutual fund that has adopted fundamental investment objectives that permit it to invest in asset classes or adopt investment strategies that are otherwise prohibited by NI 81-102*". National Instrument 81-104 *Commodity Pools*, which has long regulated so-called "commodity pools", would be repealed.

Under the proposed rule amendments, an alternative fund will generally not be subject to the same investment restrictions as conventional mutual funds, but will be subject to certain restrictions applicable to non-redeemable investment funds. The proposed rule amendments also effect some welcome changes to the investment restrictions as they apply to conventional mutual funds and some – perhaps – less welcome changes for non-redeemable investment funds.

Concentration Restrictions – Investment in the securities of any one issuer (either directly or through a specified derivative or index participation unit) will be limited to 20 percent of the alternative fund's net asset value (NAV), which compares to the 10 percent of NAV limit for conventional mutual funds. As with conventional mutual funds, the concentration limit will be based on the market value of the securities at the time of purchase. Non-redeemable investment funds, which currently are not subject to a concentration restriction under applicable securities regulations, will also be subject to the same 20 percent of NAV limit proposed for alternative funds.

Illiquid Assets – The permitted level of investment by alternative funds in illiquid assets is proposed to be the same as for conventional mutual funds – 10 percent of NAV at the time of purchase, with a hard cap of 15 percent of NAV. The proposed amendments would also introduce a new limit on investment in illiquid assets for non-redeemable investment funds of 20 percent of NAV at the time of purchase, with a hard cap of 25 percent of NAV. This proposal reflects the CSA's continued focus on liquidity management for funds and is indicative of the broader international regulatory focus in this area.

Permitted Borrowing – Alternative funds and non-redeemable investment funds will have enhanced borrowing capabilities under the proposed amendments. Alternative funds and non-redeemable investment funds will be permitted to borrow up to 50 percent of NAV, subject to the certain conditions, including

- lenders must be entities that would qualify as an "investment fund custodian" under NI 81-102 (i.e. banks and trust companies in Canada, or their dealer affiliates)
- the fund's independent review committee (IRC) must approve any borrowing where the lender is an affiliate of the fund's investment fund manager
- any borrowing agreements entered into must be in accordance with normal industry practice and must be on standard commercial terms.

Permitted Short-Selling – Alternative funds and non-redeemable investment funds will be permitted to engage in short-sales of securities up to a limit of 50 percent of NAV, with the maximum amount of securities of a single issuer (measured by aggregate market value) that may be sold short being limited to 10 percent of NAV. The CSA also proposes to exempt alternative funds and non-redeemable investment funds from the requirement to hold cash cover and from the prohibition on the use of short-sale proceeds to purchase securities other than securities that qualify as cash cover. Conventional mutual funds will remain subject to the existing limits on short-sales.

Aggregate Borrowing and Short-Selling Limit – As cash borrowing and shorting may each be considered to be a form of leverage, the proposed amendments provide for an overall limit on the use of cash borrowing and short-selling by alternative funds and non-redeemable investment funds of 50 percent of NAV.

Use of Derivatives – The proposed amendments seek to codify exemptions routinely granted to investment funds from the counterparty designated ratings and exposure limits, which are necessary as a result of the *Dodd-Frank Wall Street Reform and Consumer Protection Act* in the United States, by permitting investment funds to engage in "cleared specified derivative" transactions, which would refer to any specified derivative cleared through a "specified clearing corporation". Further, the CSA proposes to amend the custodian requirements to permit an investment fund to deposit assets with a dealer as margin in respect of cleared specified derivatives.

Alternative funds will be permitted to enter into cleared specified derivative transactions in which the derivative counterparty and/or guarantor of the counterparty does not have a "designated rating". Alternative funds would also be permitted to enter into cleared specified derivative transactions without being subject to the 10 percent counterparty exposure limit, but would be subject to the 10 percent counterparty exposure limit for other types of derivatives. Non-redeemable investment funds would continue to be exempt

from the counterparty designated rating requirement but would now be subject to the 10 percent counterparty exposure limit for derivative transactions that are not "cleared specified derivatives".

Alternative funds and non-redeemable investment funds would be exempt from the cover requirements to allow the use of derivatives to create synthetic leveraged exposure, subject to the overall limits on leverage discussed below.

Aggregate Leverage Limit – Alternative funds and non-redeemable investment funds will be permitted to use leverage through cash borrowing, short-selling and specified derivative transactions. The CSA proposes that the aggregate gross leverage exposure of an alternative fund or a non-redeemable investment fund, through any combination of these techniques, must be limited to three times (3x) NAV at all times, calculated as the sum of total amount of outstanding cash borrowed, combined market value of securities sold short and the aggregate notional amount of all specified derivative positions (including those used for hedging purposes) divided by the fund's net assets. Fund managers would be required to monitor each fund's total leverage on a daily basis. The CSA are asking for comments on the leverage calculation methodology and specifically whether derivatives exposure should be calculated on a notional basis and exclude derivatives positions used for hedging purposes.

Investments in Other Investment Funds (Fund-of-Fund Structures) – The proposed amendments seek to facilitate fund-of-fund structures by easing restrictions applicable to conventional mutual funds and alternative funds, although they make no changes to the fund-of-fund investing restrictions applicable to non-redeemable investment funds (which were more liberal than for mutual funds). Conventional mutual funds will be permitted to invest up to 10 percent of NAV in securities of alternative funds and non-redeemable investment funds, as well as continuing to be able to invest up to 100 percent of NAV in any other conventional mutual fund, provided that the underlying fund is subject to NI 81-102. The amendment proposes to remove the requirement that a conventional mutual fund may invest only in an underlying fund that files a simplified prospectus and codifies existing exemptions granted that permit conventional mutual funds to invest in ETFs. Similarly, under the proposed amendments, alternative funds may invest up to 100 percent of NAV in any other non-redeemable investment fund or mutual fund (including other alternative funds) provided that such underlying funds are subject to NI 81-102. Non-redeemable investment funds may continue to invest up to 100 percent of NAV in other investment funds.

The CSA also propose to remove the restriction providing that a conventional mutual fund may only invest in another investment fund that is a reporting issuer in the same "local jurisdiction", with the caveat that the underlying investment fund must be a reporting issuer in at least one Canadian jurisdiction.

Investment funds will remain prohibited from investing in non-prospectus qualified funds (pooled funds) and additionally, conventional mutual funds will remain unable to invest in active ETFs (i.e. funds that are not index participation units), absent an exemption.

Investment in Physical Commodities – The CSA propose to expand the scope of permitted investments in physical commodities for conventional mutual funds. Currently, conventional mutual funds may invest in gold (including "permitted gold certificates"), but may not invest in other physical commodities. The scope of permitted investments in the amended NI 81-102 would be expanded to codify exemptions that have been granted to allow conventional mutual funds to invest directly in silver, palladium and platinum in addition to gold (including certificates representing these precious metals) and to allow conventional mutual funds to obtain indirect exposure to any physical commodity through specified derivatives. Investments in physical commodities are still subject to a limit of 10 percent of a conventional mutual fund's NAV, which includes any investments in these commodities made by an underlying fund. The proposed amendment also codifies existing exemptions granted to precious metals funds to allow them to continue to invest more than 10 percent of NAV in permitted precious metals. Neither alternative funds nor non-redeemable investment funds are subject to this prohibition on investing in commodities.

DISCLOSURE, SET UP COSTS AND MARKETING OF ALTERNATIVE FUNDS

Offering Documents – Alternative funds that are not listed on an exchange will be subject to the same disclosure regime as conventional mutual funds under NI 81-101, meaning that the alternative fund will be required to prepare a simplified prospectus (SP), an annual information form (AIF) and fund facts document for each series or class of securities of the fund. The SP and fund facts will be required to include face page disclosure which identifies the fund as an alternative fund and text box disclosure which describes how the investment strategies and asset classes to be utilized by the alternative fund differ from conventional mutual funds, and any attendant risks associated with such strategies or asset classes.

All other types of investment funds (including exchange-listed alternative funds, ETFs and non-redeemable investment funds) must continue to file a long form prospectus under NI 41-101. The June 2015 proposals to implement an ETF Facts disclosure document for ETFs remains to be finalized[2].

The SP for an alternative fund will not be permitted to be consolidated with the SP for a conventional mutual fund under the proposed amendments.

Seed Capital Requirements and Responsibility for Organizational Costs – Seed capital requirements for new alternative funds would be set at the same level as for conventional mutual funds - $150,000 - and a manager would be permitted to redeem its seed capital investment once the fund has raised a minimum of $500,000 from outside investors.

Alternative funds will be subject to the same prohibition against reimbursement of organizational costs (including costs of incorporation, formation, organization as well as the costs of the preparation and filing of any of the preliminary prospectus, preliminary annual information form, preliminary fund facts, initial SP, AIF or fund facts) as conventional mutual funds. Managers of non-redeemable investment funds and exchange traded funds which are not in continuous distribution will continue to be able to pass organizational costs onto these funds.

Marketing of Prior Performance – Alternative fund managers with existing privately offered funds should be aware that the marketing rules in NI 81-102 will prohibit the linking of the performance of their existing alternative fund strategies with that of an alternative fund offered under a prospectus. Even if the existing private fund is "converted" into a NI 81-102 compliant fund, marketing of performance of the fund prior to the date of the final prospectus receipt will be prohibited.

DISTRIBUTION OF ALTERNATIVE FUNDS

The proposed amendments will not incorporate the proficiency requirements currently applicable to distributors of commodity pools under NI 81-104. Instead, proficiency requirements for the distribution of alternative funds will be addressed through the existing "know your client", "know your product" and suitability obligations of registered dealers. The CSA have acknowledged that additional education, training and experience requirements may be required for representatives of mutual fund dealers (and members of the MFDA) in order to fully understand the unique features and strategies that alternative funds may employ. As a result, the CSA explains that they intend to work with the MFDA to determine the appropriate requirements for mutual fund dealing representatives that seek to trade in securities of alternative funds.

OTHER REQUIREMENTS APPLICABLE TO ALTERNATIVE FUNDS

Alternative funds also will be subject to other requirements applicable to conventional mutual funds.

Independent Review Committee Requirement – Managers of alternative funds will be required to appoint an independent review committee (IRC) under National Instrument 81-107 *Independent Review Committee for Investment Funds* (NI 81-107). In addition to the other requirements of NI 81-107, the IRC will be required to review and approve any transaction in which the fund proposes to borrow cash from an affiliate of the investment fund manager, as described above.

Continuous Disclosure Requirements – Alternative funds will be subject to the continuous disclosure obligations contained in National Instrument 81-106 *Investment Fund Continuous Disclosure* and any investment fund that uses leverage must include disclosure about its use of leverage in the fund's interim financial reports, annual financial statements and management report of fund performance.

Compliance with Mutual Fund Sales Practices Requirements – As alternative funds will be "mutual funds", it is expected that they will be subject to National Instrument 81-105 *Mutual Fund Sales Practices*, which imposes restrictions on certain sales and compensation practices.

PROPOSED TRANSITION

If approved, the proposed amendments would come into force approximately three months after their final publication date and would immediately apply to any new investment fund that files a preliminary or final prospectus after that date. For existing funds, the proposed amendments would become applicable after an additional six months following the coming into force date of the amendments, which we interpret as nine months following the final publication date.

[2] See ***Marrying the Rules for ETFs and Mutual Funds? Canadian Securities Administrators Propose New "ETF Facts" to be Delivered to Investors Post-Trade*** Investment Management Bulletin Borden Ladner Gervais LLP June 2015.

POTENTIAL IMPLICATIONS OF THE PROPOSED AMENDMENTS

ALTERNATIVE FUNDS

The publication of the proposed amendments represents an opportunity for the managers of alternative funds to make these strategies, which were previously only offered to high net worth individuals and institutional investors in the private market, available to Canadian retail investors. This will allow managers of alternative funds to achieve a greater scale and flexibility to employ their strategies in an effective manner. At the same time, managers of alternative funds must be ready to accept a far greater level of regulation and fund governance requirements compared to the private investment fund market. Alternative fund managers must consider what adjustments they may need to make to the investment strategies they employ in order to comply with the restrictions contained in the proposed amendments and what, if any, impact such changes may have on the returns of such investment strategies.

We expect that any alternative fund manager contemplating offering funds to the public under the amended NI 81-102 would want to conduct a detailed review of its business plan filed in connection with its existing securities registrations, as well as its internal policies and procedures compliance manual, and to make any amendments or adopt additional policies and procedures as may be required in order for the manager to offer funds at a retail level in Canada.

CONVENTIONAL MUTUAL FUNDS

Conventional mutual funds will benefit from the codification of various exemptions from NI 81-102 contained in the proposed amendments, including the expanded scope of permitted investment in physical commodities, and relief from the counterparty designated ratings and exposure limits for derivatives cleared through a “specified clearing corporation”.

We expect that some conventional mutual funds will also welcome the opportunity to be able to invest up to 10 percent of NAV in underlying alternative funds and non-redeemable investment funds. This type of amendment is reflective of the CSA view that it is appropriate for retail investors to have some portion of their portfolio exposed to alternative strategies and is consistent with the main impetus to modernize the alternative funds regime for retail investors.

An existing conventional mutual fund that wishes to convert to being an alternative fund would be required to seek securityholder approval, as a change in investment objectives and strategies of this degree would no doubt be a fundamental change to the fund.

NON-REDEEMABLE INVESTMENT FUNDS

Non-redeemable investment funds will see benefit in the ability to obtain exposure to alternative funds through fund-of-fund investments. However, non-redeemable investment funds will be required to carefully review their current investment strategies and make modifications to their strategies and related compliance monitoring in order to adopt the new investment restrictions imposed by the amendments, including the 20 percent of NAV concentration limit, the introduction of restrictions on certain types of investments, the 20 percent limit on illiquid investments at the time of purchase (25 percent hard cap), the introduction of limits on borrowing, short-selling and the use of leverage and the inclusion of a counterparty exposure limit of 10 percent of NAV for derivative transactions.

In some cases, the CSA have signalled their willingness to consider whether the adoption of some of the proposed investment restrictions is also appropriate for non-redeemable investment funds.

INVESTORS

The Canadian retail investor will be the ultimate beneficiary of the proposed amendments, which will introduce a multitude of new and varied investment options that may be utilized to help achieve their investment goals. A crucial component of the proposed amendments is the “one-stop shopping” element of the proposals, which will enable investors to purchase conventional mutual funds and alternative funds under similar offering documents and through familiar distribution channels, which should facilitate comparisons between investment options and encourage both a smooth transition and rapid acceptance of the new rules.

INCLUDES COMMENT LETTERS

COMMENTS ON THE PROPOSED RULE AMENDMENTS

It will be important to provide feedback to the CSA on their proposals, particularly on whether or not the proposals for investment restrictions are practical and workable – that is, will they permit a broad range of alternative investment strategies to be offered to the retail public that are currently available only to the high net worth or institutional marketplace. Comments are due by December 22, 2016. Please contact the authors of this Bulletin or your usual lawyer in BLG's Investment Management practice group if you would like any assistance in understanding the rule amendments and how they would apply to your business or in drafting your response letter to the CSA.

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MACKENZIE Investments | CONFIDENCE IN A CHANGING WORLD

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December 22, 2016

British Columbia Securities Commission
Alberta Securities Commission
Financial and Consumer Affairs Authority of Saskatchewan
The Manitoba Securities Commission
Ontario Securities Commission
Autorité des marches financiers
Financial and Consumer 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
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Re: Re: Canadian Securities Administrators (CSA) Request for Comments dated September 22, 2016 - Modernization of Investment Fund Product Regulation – Alternative Funds

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We are pleased to provide comments on behalf of Mackenzie Financial Corporation (Mackenzie Investments) on the CSA's Request for Comments in regard to the proposed alternative funds regime.

Background – Mackenzie Investments

Mackenzie Investments is a portfolio manager and investment fund manager with total assets under management as at November 30, 2016 of approximately $63.28 billion including mutual fund assets under management of approximately $50.73 billion. Mackenzie Investments is a wholly owned subsidiary of IGM Financial Inc., which in turn

is a member of the Power Financial Corporation group of companies. We distribute our products to over 1 million clients across Canada through approximately 250 dealers representing over 30,000 financial advisors.

General Comments

Mackenzie Investments is aligned with the CSA in the desire to ensure continued access to high quality financial products for all Canadians. Mackenzie Investments is supportive of the CSA's ongoing initiative to modernize and broaden the array of products available within publicly offered investment funds. We believe the addition of alternative funds will effectively expand the investment strategies that are available for retail investors, while maintaining appropriate protections. In the current economic climate, it is essential to ensure that alternative strategies can be accessed for investors to enhance returns and reduce volatility.

We agree with most aspects of the proposed alternative fund rules which we believe at least in part are intended to give retail investors the opportunity to access investment strategies which are available to retail investors in other jurisdictions. These include event driven, equity market neutral, long/short credit, long/short equity, multi-alternative, absolute return and risk parity. We believe the name "alternative funds" and the related definition are appropriate and we are supportive of these products being sold under separate offering documents from conventional funds.

Our main concern with the proposed rules, discussed below, involves the total limitation on leverage, in particular, the component of the gross notional exposure test that measures specified derivatives exposure. While we support measuring derivatives leverage exposure on a gross notional amount basis, we believe certain derivatives trades need to be excluded from the test or measured differently to ensure the rules are sufficiently flexible to allow for the reasonable spectrum of alternative mandates the CSA envisioned under this framework. We have also provided feedback in regard to the risk classification assessment process, the proposed changes to National Instrument 81-102 related to short selling and the eventual proficiency requirements that will regulate the sale of alternative funds.

Total Leverage Limit

Mackenzie Investments agrees with the CSA's goal of imposing a limit on leverage. We understand the CSA's aim to create an objective, measureable standard to limit leverage within alternative funds. We believe the rules should establish a clear, concrete test that will allow investors to compare the maximum leverage to be employed by different alternative funds. However, we recommend several modifications to the derivatives aspect of the gross aggregate exposure calculation to ensure it is sufficiently flexible to permit alternative strategies while also achieving the goal of imposing a reasonable limit on leverage.

We assume the leverage limit is being imposed primarily to manage the overall risk associated with an investment in an alternative fund, in part to ensure that excessively speculative products are not made available to retail investors within this framework. We acknowledge that the currently proposed derivatives component of the leverage test has appeal in its objectivity and simplicity, however, we do not believe the current iteration of

the test provides an accurate or consistent indication of risk or expresses the fund's settlement obligations. Nor, as constructed, will it impose an appropriate limitation on leverage for many alternative fund mandates to operate within. We therefore recommend that the CSA consider the following modifications:

1. We recommend that specified derivatives trades made for "hedging" purposes as defined in National Instrument 81-102 be excluded entirely from the aggregate gross exposure calculation. We note that the current rules governing these trades by conventional funds suggest that derivatives trades made for "hedging" purposes do not contribute to leverage within a fund[1]. If these trades are not excluded from the alternative funds gross notional exposure (leverage) test, then alternative funds and conventional mutual funds would be subjected to contradictory treatment for these trades within the same Instrument. We do not think it was intended to impose greater restrictions for the same category of trades, especially when the restrictions would be imposed on what is meant to be a more permissive regime.

2. The currently proposed exposure test has no regard for the type of trade, including whether the fund's obligations are tied to the notional amount (long vs short position). For example, we do not believe that an out of the money long call option should contribute to leverage based on its notional amount in the same manner that a written call option would. In the former scenario the fund's exposure is tied to the premiums paid whereas in the latter the fund could be required to deliver the entire notional amount upon settlement. The notional amount calculation should be adjusted to better reflect the fund's delivery obligations which, we submit, are a better reflection of actual leverage achieved.

3. The currently proposed test does not consider the nature of the underlying interest or asset class that is subject to the trade. Two trades with equal notional exposures and different underlying interests could potentially have drastically different risk parameters. We believe the CSA should consider building in a way to adjust the leverage/exposure for certain derivatives. This approach has been employed by CFTC as a means to calculate the amount of initial margin deposited by counterparties for certain uncleared swaps. We believe for certain standardized trades it may be appropriate to adjust the amount of notional exposure that contributes to the leverage test on a similar basis.

4. Finally, the proposed rule should permit an alternative fund to enter into an offsetting derivatives transaction which would have the impact of reducing its notional exposure. For example, if market movement results in a fund

[1] *One of the stated goals of the current National Instrument 81-102 governing conventional funds is to prevent the use of specified derivatives to leverage the assets of the conventional fund (Section 4.3 of the Companion Policy). This is accomplished largely by distinguishing non-hedging and hedging derivatives trading, the latter of which are permitted to be traded without "cover" requirements.*

temporarily exceeding the gross exposure threshold, the fund should have the ability to enter into an offsetting transaction to reduce its total leverage.

We believe these exceptions are critical to ensuring the limit is appropriately flexible for alternative mandates and that it is reflective of the leverage employed within these funds. In the event the CSA is not receptive to the above-mentioned exceptions, we believe it should consider increasing the maximum leverage ratio from three to four times the net asset value of the fund. Although this would not account for the issues described above, it would allow additional flexibility for portfolio managers to engage in these techniques without meeting their leverage limit quite as rapidly.

Short Selling

The proposed rules impose a combined limit on borrowing and short selling such that borrowed cash and assets sold short cannot exceed 50% of the net asset value of an alternative fund. This means that if an alternative fund were to engage in short selling but not borrowing, its total assets sold short could represent up to 50% of net asset value.

The proposed rules, however, do not include any revisions to subsection 6.8.1(1) of National Instrument 81-102, which does not permit conventional or alternative funds to deposit portfolio assets with any one borrowing agent (that is not a custodian) in excess of 10% of net asset value. This means, in practice, the restriction gives rise to the unintended outcome of requiring an alternative fund that borrows to short sell 50% of its assets to need relationships with five separate borrowing agents in order to comply with subsection 6.8.1(1).

We therefore recommend that the CSA increase the deposit limit within subsection 6.8.1(1) of National Instrument 81-102 for alternative funds that short sell, from 10% to 25% of net asset value to allow an alternative fund manager that seeks to short sell up to 50% of assets to use two borrowing agents, as opposed to five. Without this change, we submit that alternative funds will not take advantage of the new short selling requirement, as it will be operationally impractical to initiate five separate agreements and unduly burdensome to administer.

Proficiency

We agree with the CSA's approach to not embed registrant proficiency requirements into operational regulations. We note that the CSA is liaising with the Mutual Fund Dealers Association of Canada to determine whether additional guidance is necessary in regard to the sale of alternative funds to satisfy existing registration requirements under National Instrument 31-103 *Registration Requirements.*

In our view, alternative funds do not represent a significant departure from conventional mutual funds in terms of their complexity. Both are permitted to invest in certain physical commodities, both can conduct physical short sales and both can trade in specified derivatives. The differences relate primarily to the extent to which both vehicles are permitted to undertake these and other activities.

To the extent that the MFDA proposes additional proficiency requirements for alternative funds, we strongly recommend a principles based approach. In the U.S., the Financial

Industry Regulatory Authority (FINRA) has issued principles-based guidance on the sale of complex products, including funds that have novel or intricate derivatives features, hedge funds and securitized products.[2] We believe FINRA's flexible approach to proficiency is consistent with the general proficiency requirements set forth at Section 3.4(1) of National Instrument 31-103 which state that the (registered) individual must have the "education, training and experience that a reasonable person would consider necessary to perform the activity competently."

Risk Classification Methodology

We support standard deviation based measurement as an appropriate method to determine the risk profile of investment funds, including alternative funds. To ensure comparability, alternative fund risk category assessments should be determined using the same methodology as conventional mutual funds.

We do not, however, believe that alternative funds with less than ten years history should be required to use reference index performance as contemplated within the *CSA Mutual Fund Risk Classification Methodology for Use in Fund Facts and ETF Facts*, which is expected to come into force on March 8, 2017 ("Methodology"). Given the additional flexibility inherent within alternative fund mandates to employ leverage and invest in physical commodities, there will be mandates where an appropriate reference index may not be identifiable. Overall, we submit that the discretionary nature of many alternative fund mandates further contributes to the potential misleading nature of strictly using the standard deviation of a reference index to calculate alternative fund performance. Consider an alternative fund that employs an options writing strategy. The premiums received from options writing can enhance a fund's returns over time, however, in the event of certain unanticipated market events, these strategies can experience losses that are disconnected to most reference indices, including those selected using the reference index criteria within the Methodology.

We therefore submit that the reference index requirement within the Methodology be amended to afford greater flexibility to alternative fund managers. In circumstances where the most appropriate reference index is identified in accordance with the CSA principles does not, in the opinion of the manager, accurately reflect the returns, volatility and/or portfolio of the alternative fund, the manager should be permitted to adjust the alternative fund risk rating category on a discretionary basis. In the event this discretion is exercised, the manager should be required to include fund facts disclosure describing the adjustment from the risk category associated with the standard deviation of the reference index as well as a brief explanation on the reasons for the adjustment.

[2] FINRA's Regulatory Notice 12-03 on the sale of Complex Products includes requirements that registered representatives shall: "*possess a sophisticated understanding of the payoff structure, any limit on upside potential and the risks to investors that the structure represents" (ii) "be competent to develop a payoff diagram of a structured product to facilitate his or her analysis of its embedded features*…"; and (iii) "*be trained to understand not only the manner in which a complex product is expected to perform in normal market conditions but the risks associated with the product.*"

Marketing Materials

With the introduction of a new category of investment funds, Mackenzie Investments supports responsible marketing practices. We note the CSA, and, individually, the OSC, have released guidance on investment fund marketing practices dating from 2007 to 2013.[3] We believe this collective guidance provides useful support on a variety of marketing issues with regard to investment funds, including guidance on the use of hypothetical data. We suggest an expansion of this guidance to promote responsible use of sales communications for alternative funds. Below are examples of issues that have been addressed by FINRA in various publications and may be appropriate for inclusion within future OSC guidance:

- Ensure alternative funds are positioned within appropriate sub categories. Important to ensure funds are not sold under an umbrella category. Materials should fairly describe how the alternative product functions, consistent with its simplified prospectus.

- Ensure investors made aware how the alternative fund will respond to various market events or conditions.

- Ensure investors are made aware of which strategy the portfolio managers are likely to employ in certain market conditions.

We thank you for the opportunity to provide comments on the proposed rules governing alternative funds. We would welcome the opportunity to discuss our comments with CSA representatives. In particular, we would value the opportunity to meet to discuss our suggestions to improve the derivatives component of the gross aggregate exposure test in greater detail. Please feel free to contact the undersigned or Matt Grant at mgrant@mackenzieinvestments.com if you have any questions or require additional information.

Yours truly,

MACKENZIE FINANCIAL CORPORATION

"*Michael Schnitman*"

Michael Schnitman
Senior Vice President
Head of Product

[3] OSC Staff Notice 33-729, OSC Staff Notice 81-720 and CSA Staff Notice 31-325, for example.

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

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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
Chair, Canadian Advocacy Council

mcmillan

Reply to the Attention of Margaret McNee
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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
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Me Anne-Marie Beaudoin
Corporate Secretary
Autorité des marchés financiers
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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. Borrowing

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) Historical Performance Record (Part 15 of NI 81-102)

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,

"Margaret McNee"

Margaret McNee

Cc: Jason Chertin, McMillan LLP

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Dear Sirs/Mesdames:

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

BMO Capital Markets ("**BMO CM**") and BMO Global Asset Management (which includes BMO Asset Management Inc. and BMO Investments Inc.) ("**BMO GAM**" and together with BMO CM, "**BMO**" or "**we**") appreciate the opportunity to provide comments on the Proposed Amendments and are generally supportive of the Proposed Amendments. Please note that our comments do not address non-redeemable investment funds. We believe that the proposals largely succeed in balancing retail investors' need for innovative investment solutions with risk management and investor protection concerns, subject to the following general comments below:

Definition of "Illiquid Asset" and Restrictions Concerning Illiquid Assets (Sections 1.1 and 2.4 of NI 81-102)

The Proposed Amendments specify a 10% limit for investments in illiquid assets by mutual funds at the time of purchase (with a 15% hard cap). We feel increasing the illiquid assets limit to 15% of net asset value at the time of purchase (with a 20% hard cap) for an alternative fund would be an appropriate balance between investor protection and fund manager flexibility to manage alternative strategies for performance. We note that this level of illiquid assets is in line with guidelines issued under the Investment Company Act of 1940 (the "**1940 Act**") in the U.S.

We also suggest that the definition of "illiquid asset" in National Instrument 81-102 - *Investment Funds* ("**NI 81-102**") be updated to explicitly exclude asset classes that are traded on over-the-counter ("**OTC**") markets and may be accurately priced on an arm's length basis. Many conventional asset classes, such as bonds, trade on OTC markets and the fact that a security is not quoted on a recognized marketplace does not indicate that the security is illiquid. We note that Securities and Exchange Commission (SEC) guidance considers an asset to be illiquid if it cannot be sold in current market conditions within seven calendar days without significantly changing the market value of the investment. It is our understanding that in the U.S., this determination is tested and verified by an investment fund's auditors and that this sort of market-based definition works well. We believe that a similar, market-based approach to the definition of illiquid asset under NI 81-102 would be appropriate.

Single Issuer Short Sale Limits Regarding Government Securities and Index Participation Units ("IPUs") (Section 2.6.1(c)(iv) of NI 81-102)

Section 2.1 of NI 81-102 provides exemptions to the concentration restrictions for long investments in IPUs, government securities and purchases of investment funds made in accordance with Section 2.5 of NI 81-102. We believe that a similar exemption should be integrated into the short selling restrictions in Section 2.6.1(c)(iv) of NI 81-102. This is important, among other things, to facilitate hedging of long investments permitted by the above exemptions.

Short Selling Restrictions (Section 2.6.1(c)(v) of NI 81-102)

We support the proposal for a 50% limit on short selling as set out in Section 2.6.1(c)(v) of NI 81-102 under the Proposed Amendments (the "**Short Sale Limit**") which coincides with 1940 Act limits.

However we suggest that the CSA exempt alternative funds that employ a market neutral strategy from the Short Sale Limit as it would impose a significant obstacle since such funds typically require up to 100% short positions. Although derivatives may be used to achieve similar results, it is our understanding that this may not be as cost-effective as a simple shorting of securities to pursue such a strategy. Funds that employ a market neutral strategy can be useful diversification tools for investors as they create different correlations and risk profiles than the market in general.

Counterparty Exposure Limits in Respect of Specified Derivatives (Section 2.7(4) of NI 81-102)

We suggest that the CSA maintain the counterparty exposure exemption for alternative funds as currently set out in NI 81-102.

The proposed 10% limit with any one counterparty for specified derivatives imposes significant operational constraints as existing commodity pools would be required to find at least ten different counterparties to maintain their existing specified derivatives exposure under the current rules. This proposed change would have significant operational and compliance implications for funds which engage in these transactions and would add significant transaction costs. Funds currently do not tend to enter into specified derivatives transactions with more than one or two counterparties at a time, because the administrative costs of negotiating each new transaction and the ongoing costs of dealing separately with multiple counterparties are significant. The administrative and operational costs to move from one or two counterparties to more than ten counterparties would have a material impact on the ability of funds to engage in these transactions. The Proposed Amendments would also require such funds to close out any position with a particular counterparty if such position exceeded the 10% limit. Monitoring and closing out these mark-to-market positions would impose significant compliance and operational burdens on funds.

We further suggest that the CSA amend section 2.7(5) of NI 81-102 to specify that the mark-to-market value calculation of the specified derivatives position with a counterparty will be net of any credit support provided by such counterparty where the investment fund has a legally enforceable pledge of collateral from the counterparty.

Total Leverage Limit (Section 2.9.1 of NI 81-102)

The Proposed Amendments set an overall limit on leverage by investment funds at three times the net asset value ("**NAV**") of an investment fund (the "**Total Leverage Limit**"). We are generally supportive of the Total Leverage Limit. However, we believe that the Total Leverage Limit, in its current draft form, may cause issues for fixed-income alternative funds that employ leverage to implement their investment objectives and for investment funds that engage in hedging transactions.

It is important to note that certain fixed-income strategies often use significant leverage, in excess of the Total Leverage Limit, to implement their investment objectives. Fixed-income assets are allowed high rates of margin leverage under the IIROC Rules, largely because fixed-income assets are viewed as being less volatile than equity and other investments. Equity funds that use less leverage may be riskier than fixed-income funds with the same leverage due to their underlying riskier assets. Therefore we believe that a separate higher leverage limit should be adopted for fixed-income funds. Further review of an appropriate leverage limit is warranted.

We are also of the view that alternative funds should be able to exclude hedging transactions (for example derivative transactions such as foreign exchange forwards or government bond futures) when calculating total leverage as contemplated under the Proposed Amendments, as such transactions are intended to decrease risk. We also propose that alternative funds be permitted 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 against investments hedged by such derivatives when determining an alternative fund's aggregate exposure. Accordingly, we believe that calculating notional amounts based on net exposures is the appropriate way to illustrate exposure to leverage to a retail investor.

Custodial Requirements for Alternative Funds (Part 6 of NI 81-102)

The Proposed Amendments may create significant issues in respect of the provision of prime brokerage services to alternative funds. Prime brokerage generally refers to a bundled package of services offered by investment dealers to investment funds which need the ability to borrow securities and cash in order to invest in accordance with their investment objectives. Prime brokers act as a financing counterparty by lending cash and securities to funds and they also provide a centralized account to enable custody, settlement and clearing of securities for funds. This activity requires prime brokers to take a security interest in the collateral held in such accounts and the assets of such accounts are subject to rehypothecation by the prime broker. The existing custodial requirements under NI 81-102, although not expressly prohibiting a prime broker from acting as custodian or sub-custodian to a publicly offered investment fund, contain requirements which make it practically and/or commercially unfeasible for prime brokers to act in a dual capacity.

In particular:

- Subject to certain exceptions, Section 6.4(3)(a) of NI 81-102 generally prohibits the creation of any security interest on the portfolio assets of an investment fund in a custodial or sub-custodial agreement.

- Section 6.4(3)(b) of NI 81-102 prohibits custodial or sub-custodial agreements from requiring payment of fees to a custodian or a sub-custodian for the transfer of the beneficial ownership of portfolio assets of the investment fund. One of the principal aspects of a prime brokerage agreement is the payment of fees to the prime broker in connection with the trading activities of the investment fund (i.e. the change of beneficial ownership of securities).

- Section 6.5 of NI 81-102, particularly the segregation requirements for portfolio assets which are in bearer form, may pose a significant impediment to the ability of a prime broker to also act as custodian or sub-custodian of an alternative fund because the segregation of portfolio assets in a prime brokerage agreement and as permitted under applicable IIROC Rules will typically permit these assets to be comingled with the assets of other clients of the prime broker, which is essential for the rehypothecation of such assets.

We suggest that the CSA permit registered investment dealers that are members of IIROC to act as a Canadian custodian or sub-custodian of publicly offered alternative funds ("**IIROC Custodian**") by:

- Exempting custodial/sub-custodial agreements with IIROC Custodians from the portions of Section 6.4(3) of NI 81-102 that relate to the taking of security and payment of fees.

- Exempting custodial/sub-custodial agreements from the portions of Section 6.5 of NI 81-102 that relate to the holding/segregation of portfolio assets and permit IIROC Custodians to segregate client assets in accordance with IIROC Rules 17.3 and 17.3A – *Dealer Member Minimum Capital, Conduct of Business and Insurance* and Rule 2000 – *Segregation Requirements*.

In our view, use of IIROC Custodians by alternative funds would not disadvantage retail investors because:

- IIROC Rules 17.3 and 17.3A – *Dealer Member Minimum Capital, Conduct of Business and Insurance* and Rule 2000 – *Segregation Requirements* specifically require segregation of fully-paid-for securities;
- Financial requirements as set out in NI 81-102 mean that only dealers that can demonstrate significant financial resources can act as IIROC Custodians; and
- IIROC dealers have comparable investor protection mechanisms to those of other custodians.

In addition, there could be potential additional material operational and administrative costs for alternative funds if they are not permitted to have one or more prime brokers act as the custodian or sub-custodian of the portfolio assets of the fund. In particular, if rehypothecation of portfolio assets is not possible, custodial costs borne by an alternative fund would be significantly higher.

Custodial Provisions Relating to Short Sales (Section 6.8.1 of NI 81-102)

We believe that Section 6.8.1 of NI 81-102 should be revised to permit a fund to deposit 20% (as opposed to 10% as currently proposed) of NAV with a borrowing agent (other than the fund's custodian or sub-custodian) as security in connection with a short sale (the "**10% Deposit Limit**").

Under the Proposed Amendments, an alternative fund will be able to short up to 50% of its NAV (as compared to the current 20% NAV short sale limit). Increasing the short sale limit from 20% to 50% without changing the 10% Deposit Limit will have the unintended consequence of increasing operational and administrational burdens as the alternative fund could be required to deal with up to seven different borrowing agents (as opposed to 2 or 3 borrowing agents under the current rules).

Disclosure

We urge the CSA to be consistent in the disclosure rules for all types of alternative funds and to abandon any comparisons between a "conventional" mutual fund and an alternative fund in the relevant disclosure documents. Rather, disclosure should focus on the specific features that are unique to the particular alternative fund, including, for example, investment strategies detailing specific derivative instruments, to enable investors to better understand the risks associated with their investment.

If you have any questions or comments regarding any aspect of this letter, please do not hesitate to contact any of the undersigned.

Sincerely,

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Global Head of ETFs and Chief Investment Officer,
BMO Global Asset Management

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December 22, 2016

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Dear Sirs and Mesdames:

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

We are pleased to provide comments in response to the proposed amendments (the "**Proposed Amendments**") outlined in the CSA Notice and Request for Comment published on September 22, 2016 (the "**Notice**") concerning the final phase of the CSA's modernization of investment fund product regulation (the "**Modernization Project**") which include, among other things, a comprehensive framework for the regulation of "alternative funds" under National Instrument 81-102 - *Investment Funds* ("**NI 81-102**"). This letter is a follow up to our letter dated August 22, 2013 concerning Phase 2 of the Modernization Project (the "**Previous Comment Letter**").

Specific Comments

You have asked for specific feedback with respect to certain questions in Appendix A to the Notice and the numbers and headings below correspond to your questions in the Appendix to

the extent we have feedback to provide. Defined terms used in this letter that are not otherwise defined have the meanings ascribed to them in the Notice.

1. Definition of Alternative Fund

We generally support the use of the term "alternative fund", but note that many other jurisdictions use the term "alternative fund" to connote hedge fund type structures. However, it is not apparent to us why the CSA felt the need to define an alternative fund as a type of mutual fund or to integrate alternative funds into NI 81-102. The CSA proposal for alternative funds, although more liberal in restrictions than those applied to traditional mutual funds, is still much more restricted than other funds in the global alternative fund world and as set forth below we believe a number of these restrictions should be reconsidered.

Investment Restrictions

As stated in the Previous Comment Letter, it is worth noting that investment restrictions for NRIFs are created for each specific investment strategy and asset class and this process which involves the investment fund manager, the dealers and their respective lawyers does not appear to have created any issues identified in the Notice. The investment restrictions are clearly disclosed in the prospectus of each NRIF and we would like to reiterate that we believe that disclosure is a better approach for NRIFs than a rules based approach which by its nature is less flexible and has the potential to limit investment options.

3. Concentration

We do not generally believe that an upper limit or hard cap on concentration is required for an alternative fund or a NRIF. While we agree with the CSA that a 10% or 20% concentration limit is typical in the majority of NRIFs, we do not believe that it is necessary to codify 20% as an absolute limit for NRIFs. NRIFs, like alternative funds, are not meant to provide investors with a complete investment solution and therefore creating a limit of 20% does not seem appropriate. If a hard cap is imposed for NRIFs, we would suggest a broader fixed portfolio exemption than is currently contemplated. In particular, any proposed NRIF that by its investment strategy has a "rules based" or formulaic approach to investing should be exempt from the concentration restriction including with respect to any rebalancing or portfolio substitutions.

5-7. Illiquid Assets/Redemptions

As described in the Previous Comment Letter with respect to NRIFs, as NRIFs do not have the same liquidity requirements with respect to funding ongoing redemptions as mutual funds, we think it is appropriate that they have the ability to hold larger amounts of illiquid assets. We do not agree with the proposed cap on the amount of illiquid assets held by a NRIF at 20% of NAV at the time of purchase (with a hard cap of 25% of NAV). The fact that NRIFs at most have a NAV redemption annually means that their need for liquidity is significantly less than that of a mutual fund. In addition, in circumstances where a NRIF is investing in a less liquid asset, the amount of notice required to be given in connection with the annual NAV redemption is often extended to take this fact into account. This is an example of the consultative approach between the investment dealers and investment fund manager working together on a NRIF to identify appropriate structural features based on the asset class of the NRIF.

Imposing liquidity requirements on funds that do not match a fund's terms and conditions and investor expectations may impose unwarranted costs on investors including restrictions that limit

innovation and differentiation. We also do not believe that securities regulators should seek to impose portfolio restrictions for other reasons such as "safety" or capital preservation which is better left to investment dealers and investment fund managers working together to assess and manage in the context of the market.

8. Borrowing

We do not agree with the proposal limiting alternative funds and NRIFs to borrowing only from entities that meet the definition of a custodian for investment fund assets in Canada. A fund that borrows from a lender is not subject to the credit risk of that lender and therefore it is not clear what potential harm the CSA is attempting to address with this proposal. The proposal has the potential to increase the cost of borrowing for funds by providing fewer alternatives from which to borrow.

10. Total Leverage Limit

We believe that any leverage limit imposed by the CSA should take into account offsetting or hedging transactions to reduce a fund's calculated leverage exposure. Any specified derivative that is not typically expected to create leverage should be excluded from a fund's leverage calculation. If the CSA is intent on limiting leverage for NRIFs and alternative funds it should focus on investments that actually create leverage in order to ensure that such limits do not have the unintended consequence of limiting legitimate hedging strategies.

16. Transition

We do not believe that a transition period is appropriate and that funds that are in existence prior to the coming-into-force date of the Proposed Amendments should be grandfathered from the investment restriction changes. The rationale for this is that existing funds at that time will have been sold on a specific basis to investors and investors will expect that they have the benefit of the investment strategy that was sold to them when they acquired the applicable fund. If funds are required to transition, the impact would be to effectively substitute the CSA's views as to appropriate portfolio management strategies for those of the portfolio managers who created the fund and we do not feel that that would be appropriate.

Other Comments

Dodd-Frank Relief

We support the codification of the exemptive relief granted to mutual funds from the counterparty designated rating requirement of s. 2.7(1) of NI 81-102, the counterparty exposure limits of s. 2.7(4) of NI 81-102 and the custodian requirements of Part 6 of NI 81-102 with respect to cleared specified derivatives. However, in our view, the wording of the proposed amendments in s. 6.8 does not accomplish this as it relates to the custodian requirements. The stated intention of the proposed amendments in s. 6.8 is to exempt the custodian requirements for "cleared specified derivatives". The new definition of "cleared specified derivatives" captures both exchange traded and over-the-counter (OTC) derivatives, as intended. However, the current wording of this exemption only applies to clearing corporation options, options on futures or standardized futures, all of which are exchange traded transactions and therefore, simply substituting "clearing corporation options, options on futures or standardized futures" with "cleared specified derivatives" in s. 6.8 will not work.

Specifically, under s. 6.8(1), the proposed amendment allows portfolio assets to be deposited as margin for cleared specified derivatives if such margin is being deposited with a "dealer that is a member of an SRO that is a participating member of CIPF". However, the vast majority of OTC derivative transactions entered into in Canada between Canadians involve a Canadian bank, as opposed to a dealer. Therefore, in our view, s. 6.8(1), as amended, should also include a reference to a Canadian bank.

In addition, with respect to s. 6.8(2)(a), OTC derivatives entered into with foreign counterparties may not be with a "dealer" that is a member of a futures exchange or is a member of a stock exchange. However, those foreign counterparties are likely banks or dealers who are participants or members of a centralized clearing corporation. Therefore, in our view, s. 6.8(2)(a), as amended, should include a reference to a bank or dealer that is a member of a "regulated clearing agency".

Counterparty Requirements

We do not support the removal of the exemption for alternative funds and NRIFs from the exposure limits under s. 2.7(4) and s. 2.7(5) of NI 81-102, or the addition of s. 2.1(1.1) of NI 81-102 as it applies to prepaid specified derivatives. A prepaid specified derivative means that, upon entering into the transaction, the investment fund pays all of its obligations up front and therefore has no further obligations under the transaction. These types of transactions are beneficial to investment funds, allowing them to defer the recognition of amounts for tax purposes until the maturity of the prepaid specified derivative.

In fact, we would support an exemption for any investment fund from s. 2.1, s. 2.4, s. 2.7(4) and s. 2.7(5) of NI 81-102 (the "**Applicable Sections**") with respect to a prepaid specified derivative transaction, as long as (i) the investment fund's counterparty has a designated rating at all times, and (ii) the counterparty's obligations under the prepaid specified derivative transaction are fully collateralized. For this purpose, the term "fully collateralized" means that the collateral held by the investment fund plus the prepaid specified derivative is marked to market on a weekly basis and the amount of collateral will be adjusted each week to ensure that the market value of the collateral held by the investment fund will be equal to the mark-to-market value of the corresponding prepaid specified derivative. We submit that, as long as those two conditions are met, the investment fund is fully protected and should not be prevented from entering into a prepaid specified derivative which it would otherwise be pursuant to the Applicable Sections.

Definition of Illiquid Assets

Further to the Prior Comment Letter, we believe that the definition of illiquid asset in NI 81-102 as currently drafted does not reflect the current reality of the market and would suggest that prior to the CSA extending the reach of this definition to NRIFs and alternative funds that this definition be updated or, at the very least, clarified. Specifically, the reference to ". . . through market facilities on which public quotations in common use are widely available . . ." raises the question as to whether asset classes such as senior loans and/or high yield bonds would technically be deemed to be an "illiquid asset" in spite of the fact that there are deep and liquid markets for both of these asset classes. Accordingly, we believe this definition must be updated.

Status of an "alternative fund"

We think that an alternative fund should have the flexibility to be either a mutual fund or a NRIF. Practically, in order to be listed, an alternative fund could not be redeemable on demand. Such a fund would be able to adopt the redemption feature of a NRIF with an annual redemption at NAV. We also think that an unlisted alternative fund should be able to adopt a redemption frequency of its choosing such as monthly, quarterly or semi-annually.

* * * * * * * * *

Prior to implementing the Proposed Amendments, we believe it will be beneficial for the CSA to continue to consult with industry participants in a meaningful way.

Thank you for the opportunity to comment on the Proposed Amendments. We would be happy to discuss any of the above with you further. If you have any questions, please do not hesitate to contact Andrew Armstrong or Michael Eldridge.

Yours truly,

McCarthy Tétrault LLP

(Signed) "Andrew Armstrong"

Andrew R. Armstrong

AA/mt

TD Securities

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British Columbia Securities Commission
Alberta Securities Commission
Financial and Consumer Affairs Authority of Saskatchewan
Manitoba Securities Commission
Ontario Securities Commission
Autorite 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

December 22, 2016

Delivered to:

The Secretary
Ontario Securities Commission
20 Queen Street West, 22nd Floor
Toronto, Ontario M5H 3S8

Via email to: Comments@osc.gov.on.ca

December 22, 2016

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

Dear Sirs/Mesdames:

TD Securities Inc. ("TD Securities") is appreciative for the chance to comment on the Canadian Securities Administrators proposed amendments on the Modernization of Investment Fund Product Regulation – Alternative Funds.

TD Securities is a leading securities dealer in Canada and a top rated Prime Broker. TD Securities has been providing Prime Brokerage Services to alternative investment managers in Canada since 2001.

TD Securities is very supportive of this initiative to make alternative funds available to

Canadian retail investors under National Instrument 81-102 Investment Funds. TD Securities is a leading Canadian Prime Broker and would like to comment on Part 6, Custodianship of Portfolio Assets as we believe that the Proposed Amendments would benefit with some additional modifications. Specifically that qualifying Canadian prime brokers be permitted to act as a custodian of 81-102 regulated alternative funds. We further believe that such modifications are beneficial in order to reflect the operational activities of alternative funds, enhance and modernize the existing regime and ultimately provide Canadian retail investors with more innovative investment products in a way that is both appropriate from a risk perspective as well as being economical and efficient.

Under the Proposed Amendments, alternative funds would be required to retain a custodian for the assets of the fund in a manner similar to that of standard mutual funds. Furthermore, custodians of the assets of alternative funds would be required to follow the same requirements as custodians of conventional mutual funds.

The operational reality for most alternative funds, as a result of the amount of short selling, borrowing and frequency of trading they conduct require them to engage the services of at least one prime broker, but frequently more to custody the majority of their funds' assets. We submit that the proposal to require a separate custodian for the portfolio assets of an alternative fund does not provide any significant additional safeguards for the portfolio assets and would result in increased costs and operational complexities for alternative funds.

Furthermore, prime brokers usually do not act as custodians for conventional mutual funds for several reasons including:

(i) the qualification requirements under Section 6.2 of NI 81-102;
(ii) the prohibition on custodians taking security over portfolio assets of investment funds in Section 6.4(3)(a) of NI 81-102;
(iii) the prohibition on the charging of fees for the transfer of beneficial ownership of portfolio assets in Section 6.4(3)(b) of NI 81-102; and
(iv) the requirements relating the segregation of assets in Section 6.5 of NI 81-102.

Canadian prime brokers, as members of the Investment Industry Regulatory Organization of Canada ("IIROC") must strictly follow the requirements associated with extending margin and the segregation of assets, as set out by IIROC. Prime brokerage relationships are governed by a prime brokerage agreement which clearly outlines the services and the manner in which they are performed to an alternative fund. We believe that in addition to the operational benefits and cost savings listed above there are sufficient safeguards in place to effectively protect client assets, specifically:

- Cash in a prime brokerage account is not segregated and may be used by the Prime Broker subject to limits set and monitored by IIROC. A prime broker is

liable as a debtor to pay the alternative fund, as creditor, all such amounts.

- A prime broker holds all securities in its accounts for the alternative fund. In a cash account, all securities are fully paid for and are segregated (either in bulk with other client assets or specifically for an alternative fund if a bare trust agreement is entered into).

- In a margin account, alternative funds may borrow against portfolio securities to the extent of their margin value. The securities borrowed against, based on their margin value are not segregated by the prime broker. Short positions in the account that cannot be covered by available cash may also result in securities becoming un-segregated.

- Under IIROC rules, a prime broker may use only un-segregated securities in their business and only to the extent needed to cover a margin loan. For example, if a client has securities worth $1,000 in its prime brokerage account and owe $100 on a margin loan, the prime broker would only be able to use securities having a total margin value of $100. Prime brokers use these securities in the normal course of their business.

- IIROC regulations require firms to review its segregation at the account level each day and to correct any deficiencies (IIROC Rules 2000.4 to 2000.6). A prime broker must take immediate action to correct any segregation deficiency (IIROC Rules 2000.8-9).

TD Securities feels that IIROC registered dealers who meet the criteria to act as a custodian under Section 6.2 of NI 81-102 (specifically, the criteria in Section 6.2(3) (a) and (b), requiring $10 million of equity and guarantee by the parent bank) should be permitted to act as the custodian or sub-custodian of an alternative fund.

Permitting prime brokers of alternative funds to also act as custodian of the fund would save costs (by eliminating additional counterparties) and would not subject the portfolio assets of the alternative fund to any additional risk as prime brokers qualified to act as custodians will have sufficient capital and must act in accordance with IIROC rules and guidelines when taking and realizing on security or in connection with the segregation of assets.

In addition, Section 6.8.1 of NI 81-102 currently permits a fund to deposit up to 10% of NAV with a borrowing agent, other than its custodian or sub-custodian, as security in connection with a short sale (the "10% of NAV Limit"). In practice, a borrowing agent generally requires that the proceeds from the short sale, plus additional collateral be held as security. Under the current NI 81-102 aggregate short sale restriction of 20% of a fund's NAV, this practice results in the need for at up to two or three dealers/borrowing agents to facilitate and permit a fund to short the maximum 20% of its NAV.

However, the Proposed Amendments will permit an alternative fund to short up to 50% of its NAV, without any change in the custodial provisions set out in Section 6.8.1 which

presents both practical and operational issues for alternative funds. For example, under margin rules established by IIROC, an alternative fund entering into a short sale transaction for an equity security eligible for reduced margin would be required to post 130% of the market value of the short position as margin (security). As a result, an alternative fund that wishes to take full advantage of the increased short sale limits (50% of NAV) would be required to deal with 7 separate borrowing agents (other than the custodian) in order to comply with the 10% of NAV Limit in Section 6.8.1. A similar situation would be experienced for other asset classes such as fixed income and FX forward transactions. This would not be practically feasible and would lead to operational and administrative inefficiencies and significantly increased costs for alternative funds including:

- the time and effort to evaluate and sign multiple prime brokerage/dealer arrangements will be significant and costly for alternative funds.
- Requirement for additional staff to manage daily operational activities such as margin, reconciliations, settlements and tax reporting
- greater costs from the fund administrator due to increased book-keeping and reconciliation requirements.
- smaller accounts would mean less leverage to negotiate favourable pricing and terms of service with prime brokers/dealers.
- the requirement to locate multiple suitable prime brokers may be challenging due to the size of the industry in Canada; and
- other solutions (such as the use of tri-party arrangements) that may allow an alternative fund to comply with the 10% of NAV requirement could be operationally challenging and add additional costs for the alternative fund.

We note that if prime brokers were permitted to act as custodians of alternative funds as we have suggested above, the current language in section 6.8.1 of the Proposed Amendments would not need to be amended.

Thank you for the opportunity to provide you with our comments. Please feel free to contact me should you have any questions or wish to discuss further.

Yours truly,

Steve Banquier
Managing Director

TD Securities

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December 22, 2016

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

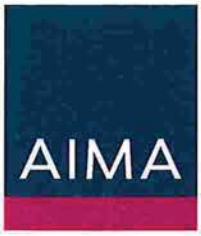
Delivered to:

The Secretary *Ontario Securities Commission* *20 Queen Street West* *19th Floor, Box 55* *Toronto, Ontario, M5H 3S8* *comments@osc.gov.on.ca*	*Me. Anne-Marie Beaudoin* *Corporate Secretary* *Autorité des marchés finaciers* *800, square Victoria, 22e étage* *C.P. 246, tour de la Bourse* *Montréal (Québec) H4Z 1G3* *consultation-en-cours@lautorite.qc.ca*

Dear Sirs/Mesdames:

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

This comment letter is submitted on behalf of the Canadian section ("AIMA Canada") of the Alternative Investment Management Association ("AIMA") and its members to provide our comments to you on the legislation referred to above.



About AIMA

AIMA was established in 1990 as a direct result of the growing importance of alternative investments in global investment management. AIMA is a not-for-profit international educational and research body that represents practitioners in alternative investment fund, futures fund and currency fund management - whether managing money or providing a service such as prime brokerage, administration, legal or accounting.

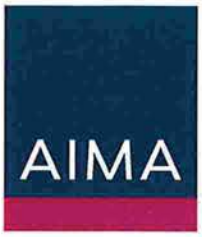
AIMA's global membership comprises over 1,700 corporate members in more than 50 countries, including many leading investment managers, professional advisers and institutional investors. AIMA Canada, established in 2003, now has more than 130 corporate members.

The objectives of AIMA are to provide an interactive and professional forum for our membership and act as a catalyst for the industry's future development; to provide leadership to the industry and be its pre-eminent voice; and to develop sound practices, enhance industry transparency and education, and to liaise with the wider financial community, institutional investors, the media, regulators, governments and other policy makers.

The majority of AIMA Canada members are managers of alternative investment funds and fund of funds. Most are small businesses with fewer than 20 employees and $50 million or less in assets under management. The majority of assets under management are from high net worth investors and are typically invested in pooled funds managed by the member. Investments in these pooled funds are sold under exemptions from the prospectus requirements, mainly the accredited investor and minimum amount exemptions. Manager members also have multiple registrations with the securities regulatory authorities: as Portfolio Managers, Investment Fund Managers and in many cases as Exempt Market Dealers. AIMA Canada's membership also includes accountancy and law firms with practices focused on the alternative investments sector.

This comment letter is the product of a working group of AIMA Canada members representing a broad cross-section of the alternative funds industry comprised of a cross-section of large and small fund managers who employ a variety of alternative investment strategies (some of whom currently have publicly offered investment fund products) and service providers such as accounting firms, investment dealers (prime brokers) and law firms.

For more information about AIMA Canada and AIMA, please visit our web sites at canada.aima.org and www.aima.org.



Comments

Set out below are our comments on the Proposed Amendments, broken down by the broad categories set out in the Notice and Request for Comment. Where relevant, we have also responded to the specific questions posed by the Notice and Request for Comment, which have been replicated in each section for ease of reference.

1. General Comments

AIMA Canada strongly supports the initiative to make alternative funds available to retail investors in Canada under National Instrument 81-102 Investment Funds ("NI 81-102" or the "Instrument") and we feel that, overall, the CSA have made a highly commendable effort in striking the appropriate balance amongst the investment restrictions, disclosure requirements and proposed distribution channels for alternative funds. However, we believe that there are several modifications to the Proposed Amendments and some additional amendments which, if adopted, will assist in fully realizing the goal of modernizing the existing commodity pool regime and providing Canadian retail investors with access to more innovative investment strategies in a manner which is efficient as well as appropriate from a risk perspective.

In considering comments received and potential changes to the Proposed Amendments, we urge the CSA to keep in mind the impact of any new requirements or regulations on the structuring and operating costs of smaller investment managers who may wish to offer investment products under NI 81-102. If the bar to entry is set too high, it would be prohibitive for the majority of the smaller investment managers to contemplate providing alternative funds to retail investors in Canada and only the largest institutions, such as Canadian banks and large mutual fund companies that have the resources and existing distribution networks would end up benefiting from the Proposed Amendments.

2. CSA Questions

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?

Response:

AIMA Canada agrees with the replacement of the term "commodity pool" with "alternative fund" and with the use of the term "alternative fund" in NI 81-102. The term "alternative fund" and the associated definition of this term in the Proposed Amendments is more representative of the various types of investment strategies that can be implemented in this category of investment funds.

Under the Proposed Amendments the CSA has proposed to adopt a similar approach to the definition of "alternative fund" in NI 81-102 as is currently used to define a "commodity pool" in NI 81-104. We would recommend that the definition of "alternative fund" be slightly modified as follows to more closely parallel the stated approach of the Proposed Amendments and account for the operational distinctions between alternative funds and conventional mutual funds:

> "alternative fund means a mutual fund**, other than a precious metals fund,** that has adopted fundamental investment objectives that permit it to invest in asset classes**,** ~~**or adopt**~~ **use** investment strategies **or implement operational features that are not permitted by this Instrument** ~~**that are otherwise prohibited**~~ but for **certain** prescribed exemptions ~~**from Part 2 of**~~ **contained in** this Instrument;"

We would also like to bring the CSA's attention the fact that there are a number of conventional mutual funds that are currently offered that incorporate the terms "Alternative" or "Liquid Alternative" in the name of the fund. As part of the Proposed Amendments, we would expect that guidance on this point would be included in the Companion Policy to NI 81-102 that these funds would either have to convert to an alternative fund or be required to change their fund names to remove these references in order to avoid potential confusion with new alternative funds among investors. Similarly, new investment funds offered under NI 81-102 should not be permitted to use the word "alternative" in their fund name in a manner that suggests that they are an alternative fund in order to prevent confusion in the market.

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.

Response:

Generally speaking, we believe that most traditional alternative investment strategies currently offered on a private placement basis to high net worth investors would be permitted (in some cases with minor modifications) under the definition of "alternative fund" and the investment restrictions contained in the Proposed Amendments. However, we note that the leverage limits on alternative funds in section 2.9.1 of the Proposed Amendments will negatively impact the ability of managed futures, relative value and global macro strategies to operate efficiently. In addition, as discussed in more detail below, the ability to offer market neutral strategies would be severely impacted and the single issuer shorting restrictions will significantly hamper alternative strategies that hedge risk through the use of instruments such as government securities and index participation units.

(a) Market Neutral Strategies Should be Eligible to be Offered as Alternative Funds

While not a separate asset class, market neutral is a common investment strategy that will be particularly affected for alternative funds under the Proposed Amendments.

The investment objective of a market neutral strategy is to remove market risk (i.e. the risks of significant swings in the market) by balancing long and short positions in an effort to provide returns in all market conditions. A market neutral strategy can provide true diversification in an investment portfolio as it is intended to be uncorrelated to the market. However, in order to employ a true market neutral strategy, a fund must be permitted have short and long positions of up to 100% of net asset value ("NAV"). Given the maximum short position limit of 50% of NAV for alternative funds in Section 2.6.1(c)(v) of NI 81-102, it would be practically impossible for a true market neutral investment strategy to be offered as an alternative fund.

Although it may be technically possible for an alternative fund to replicate a market neutral strategy under the Proposed Amendments through a combination of short-selling and specified derivatives, such an approach would be inefficient and more costly to implement than a "pure" market neutral strategy.

We submit that market neutral strategies can play an important role in removing market risk in an investor's portfolio and should be eligible to be offered as an alternative fund under the Proposed Amendments. This could be accomplished by including a definition of "market neutral fund" in the Proposed Amendments as follows:

"market neutral fund" means an alternative fund that has

> adopted a fundamental investment objective of maintaining a neutral exposure to a broad group of securities identified by sector, industry, market capitalization or geographic region through the use of long positions and short positions

A corresponding exception to the 50% of NAV short sale limit could then be included for market neutral funds which would permit such funds to have short positions up to 100% of NAV.

(b) Government Securities and IPUs Should be Exempt from Single Issuer Short Sale Limit

At present, there are exemptions from the concentration restriction in section 2.1 of NI 81-102 for government securities, index participation units ("IPUs") issued by investment funds as well as investment funds purchased in accordance with the requirements of section 2.5 of NI 81-102 (which would include exchange traded funds that do not qualify as IPUs). There are similar exemptions from the control restriction in section 2.2 of NI 81-102.

We submit that, as is the case for long positions, government securities, IPUs and securities of other exchange traded funds should correspondingly be exempt from the single issuer concentration limit of 10% of NAV of the fund contained in subsection 2.6.1(iv) of NI 81-102. Such a change would permit a greater variety of risk-reducing hedging strategies to be offered to retail investors in alternative funds.

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.

Response:

AIMA Canada supports the concentration limit of 20% of NAV for alternative funds measured as at the time of purchase. However, we do not support the introduction of an upper limit or hard cap on concentration. The imposition of a hard cap concentration limit could result in forced sales of assets with higher transactional costs at distressed prices which would not be in the interests of

investors. We submit that not having a hard cap allows alternative funds to better manage an orderly unwind of positions in excess of the 20% concentration limit thereby maximizing disposition proceeds and contributing to a lower level of market volatility.

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.

Response:

AIMA Canada submits that the illiquid asset limit for alternative funds be raised to 15% of NAV (with a hard cap of 20% of NAV). We believe that these increased limits are consistent with limits on illiquid assets in other jurisdictions such as the United States (15% of NAV limit) and would permit much more flexibility for alternative investment strategies and allow for exposure for retail investors to additional alternative asset classes under NI 81-102.

In connection with the Proposed Amendments, we would strongly encourage the CSA to use this opportunity to clarify the definition of "illiquid asset" in NI 81-102. The definition currently includes such terms as "readily disposed of", "market facilities", "public quotations" and "restricted securities" that are not defined and in respect of which there is no broad consensus within the industry. As such, the term continues to be difficult to interpret and apply in practice, particularly in respect of significant asset classes including syndicated loans, high yield debt, corporate bonds and emerging-market sovereign and quasi-sovereign bonds that trade primarily in the over-the-counter markets ("OTC").

We submit that the CSA should amend the definition of "illiquid asset" to expressly include OTC pricing that is determined on an arm's length basis and remove references to market facilities and public quotations to better reflect industry practices with respect to these types of securities. In the alternative, we submit that the CSA should adopt the approach taken by the United States Securities and Exchange Commission ("SEC") for open-ended funds under Rule 22e-4 adopted by the SEC in an October 13, 2016 release [available at: https://www.sec.gov/rules/final/2016/33-10233.pdf]. Under Rule 22e-4, an illiquid investment is an investment that the fund reasonably expects cannot be sold in current market conditions in seven calendar days without significantly changing the market value of the investment. This definition replaces longstanding SEC guidance that a fund asset should be considered illiquid if it cannot be sold or disposed of in the ordinary course of business within seven (7) days at approximately the value ascribed to it by the fund. The two components

of the SEC liquidity test: (a) the number of days required to achieve liquidity and (b) a sale price that is not significantly different from the market value of the investment, we submit, are more relevant than the nature of the market or quotations associated with such liquidity.

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.

Response:

We agree that the CSA should take into account redemption frequency when considering a fund's need, if any, for liquidity. Generally speaking, we submit that liquidity is of limited relevance or concern where an alternative fund or a non-redeemable investment fund have limited redemptions and of no relevance or concern where such a fund is not redeemable. Our view is consistent with the International Organization of Securities Commissions ("IOSCO") principles on liquidity. The alignment of liquidity with the redemption obligations and other liabilities of open-ended funds is a principle recommended in IOSCO's "Principles on Suspensions of Redemptions in Collective Investment Schemes" [available at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD367.pdf] and reiterated in a report published in March 2013 entitled "Principles of Liquidity Risk Management for Collective Investment Schemes" in which they recommended fifteen principles
available at [http://www.iosco.org/library/pubdocs/pdf/IOSCOPD405.pdf]

Redemptions and NAV Calculation

We would like 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 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) 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 disconnect will exist 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 for the first or second business day provided for redemptions described above does not exist.

While we acknowledge that the Proposed Amendments do not prescribe any particular redemption frequency for alternative funds, the obvious problem for alternative funds offering weekly or even monthly purchases and redemptions as of a specific day ("Dealing Days") is that they will have multiple issue and redemption prices on any particular single Dealing Day as they will be required to calculate NAV on a daily basis and could potentially receive (purchase and/or redemption) orders each day of the week. Taken to its extreme, an alternative fund with a monthly Dealing Day may be required to issue securities at up to 30 different NAVs on the same Dealing Day.

If this issue is not addressed, the mismatching of the issue and redemption prices with the NAV on the particular Dealing Day 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** ~~**first or 2nd business day**~~ 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.

We would encourage the CSA to adopt a consistent approach for the purchase and redemption of securities of alternative funds similar to the approach to the payment of incentive fees in the Proposed Amendments (Section 7.1(2)). Specifically, an alternative fund should be required to describe its purchase and redemption procedure in its simplified prospectus (including details relating to the frequency of purchases and redemptions).

Another example of the problem would be for alternative funds that adopt a

"fund of funds" investment strategy as permitted under NI 81-102 and allocate all or a significant portion of the fund's investment portfolio to non-redeemable investment funds. It would be nearly impossible for such a fund to comply with the next NAV redemption requirements that would be applicable to alternative funds under the Proposed Amendments because of the infrequent redemption schedule of non-redeemable investment funds and the trading price (usually at a discount to NAV) being the only source of liquidity. Alternative funds would be better able to manage their redemption schedule if the redemption price payable is permitted to be based on the NAV at the regularly predetermined Dealing Day.

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).

Response:

AIMA Canada does not express any view or opinion at this time with respect to the proposed cap on the amount of illiquid assets held by a non-redeemable investment fund as our membership is composed primarily of managers of hedge funds, fund of funds and service providers with businesses and practices focused on the alternative investment sector (but focused less on non-redeemable investment funds).

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.

Response:

For the reasons mentioned in our response to Question 6 above, AIMA Canada does not express any view or opinion at this time with respect to whether a

different limit on illiquid assets should apply in circumstances where a non-redeemable investment fund does not allow its securities to be redeemed at NAV.

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.

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.

(a) *Prime Brokers*

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* ("NI 31-103"), 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.

We further submit that the alternative qualification requirement in Section 6.2(3)(b) of NI 81-102 that the bank has assumed responsibility for all of the custodial obligations of the dealer should remain unchanged.

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 the Investment Industry Regulatory Organization of Canada ("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.

(b) *Foreign Lenders*

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 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 **or 6.3**;"

(c) *Netting of Cash and Cash Equivalents*

We recommend that the proposed cash borrowing limit of 50% of NAV under the Proposed Amendments should be calculated net of any cash and cash equivalents held in the same account.

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.

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 pool. As the investment strategies of these existing funds were established to comply with the current regime, we recommend that these commodity pools be grandfathered in 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 through specified derivatives will result in the investment strategy used by the pool becoming wholly ineffective and requiring such commodity pools to cease operations.

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?

Response:

AIMA Canada has significant concerns at a global level regarding the proposal to restrict total exposure for alternative funds through borrowing, short selling or the use of specified derivatives to the proposed limit of 300% of the fund's NAV in section 2.9.1 of NI 81-102. As currently proposed to be calculated and coupled with a ceiling of 300% of NAV, the leverage limit not only would have a disastrous impact on some existing commodity pools, it would also have a significant negative impact on the ability to offer effective managed futures, relative value, market neutral and global macro alternative investment strategies.

We would encourage the CSA to consider removing the hard leverage limit of 300% of NAV from section 2.9.1 and to instead require disclosure of the maximum amount of leverage the alternative fund may use and the method for calculating leverage by the alternative fund. Removal of the 300% leverage limit would permit existing commodity pools to continue to operate and would broaden the types of alternative strategies that could be made available to retail investors under NI 81-102.

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.

For the information of the CSA, we attach as Appendix "A" to this Comment Letter an AIMA White Paper comparing leverage measures for investment funds between the United States and the United Kingdom.

Notwithstanding the above, if the CSA decide to retain the 300% of NAV total leverage limit in the Proposed Amendments we submit that alternative funds should be able to subtract or disregard certain offsetting transactions and positions in specified derivatives that do not create leverage to reduce their calculated leveraged exposure.

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 or to exclude all hedging transactions from the calculation of total leverage. Although, certain offsetting transactions described below should be specifically excluded

We recommend that immediate offsetting transactions in fungible securities that do not create any additional leverage or exposure and should be disregarded for the purposes of the calculation. By way of example, we note that IIROC Rule 100.4 addresses a variety of offsetting positions which are generally not included in the calculating leverage. The essential features of these transactions is that the long position is fungible into the short position and is convertible (however, any costs of converting the offsetting position would be included in the leverage calculation).

We also recommend that alternative funds, in determining the aggregate gross exposure, be permitted 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.

In addition, we recommend that the Proposed Amendments include a carve-out provision that would permit an alternative fund, in determining aggregate gross

exposure, to disregard any specified derivatives entered into for the purpose of specifically offsetting: (i) foreign currency exposure; (ii) interest rate exposure; and (iii) single-name credit exposure, as these transactions are entered into to eliminate economic exposure in whole or in part. The carve-out provision would permit an alternative fund to exclude from its aggregate gross exposure the notional amounts associated with specified derivative transactions that are entered into by the alternative fund to specifically offset foreign currency exposure or interest rate risk of the fund's portfolio assets, as well as single-name credit default swaps to offset the credit risk of fixed income securities issued by a single debt issuer.

A fund that wants to fully or partially neutralize the foreign currency, interest rate or credit exposure of specific investments by entering into a specified derivative should be able to disregard the notional amount of the offsetting transaction for the purposes of the fund's overall leverage limit.

Our proposed carve-out for these offsetting transactions is not designed to enable a fund to disregard the notional amount of all specified derivative transactions involving foreign currency, interest rates or credit exposure. Rather, the provision would only apply to specified derivative transactions that directly offset or reduce risks associated with all or a portion of an existing investment or position of the alternative fund. These types of transactions do not create leverage or increase a fund's net exposure to leverage and are some of the most common specified derivative transactions entered into for the purposes of managing risk.

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.

Response:

Generally speaking we agree that the notional amount of a specified derivative does not always reflect the way in which the fund uses the derivative and that it is not a direct measure of risk. The obvious example being that two different specified derivatives having the same notional amount but different underlying reference assets may expose a fund to very different investment risks. AIMA's position is that there should be multiple (rather than a single) measures of

leverage used in order to address the variability of strategies in the alternative investment universe and that clear disclosure be used to outline how leverage is being used to either enhance returns, or in many cases, to combine related securities in an effort to reduce risk in the investment portfolio.

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.

Response:

For the reasons mentioned above, AIMA Canada does not express any view or opinion at this time with respect to whether there any identifiable categories of non-redeemable investment funds that may be particularly impacted by any of the Interrelated Investment Restrictions.

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.

Response:

We submit that it may be difficult to include all of the information contemplated by the CSA for an alternative fund in the text box disclosure of the fund facts document and fit within the space constraints of the document. We suggest that it would make more sense to include a description of the asset classes and/or investment strategies used by the alternative fund that cause it to fall under the definition of "alternative fund" in NI 81-102 under the description of what the fund invests in the fund facts document and to use the text box disclosure to highlight any differences in the redemption terms for an alternative fund compared to a conventional mutual fund as well as the sources and uses of leverage any specific risk factors that an investor should consider as a result of the asset classes invested in or investment strategies utilized by the

alternative fund to either enhance returns or reduce specific risks in the fund's investment portfolio. We submit that these changes would make the fund facts document significantly more meaningful to retail investors.

AIMA Canada strongly objects to any suggestion that alternative strategies may "affect investor's chance of losing money on their investment in the alternative fund" as was commonly the case for warnings included in the prospectus of commodity pools. Each alternative fund should be evaluated on the basis of the particular investment strategies and asset classes in which it invests and clear disclosure of any risks that should be considered in conjunction with such strategies or asset class should be made in the fund's disclosure documents. We note that to require any disclosure for alternative funds but not for non-redeemable investment funds or conventional mutual funds implies that alternative funds are riskier and more likely to lose money when this is not the case. We do not consider such a distinction to be warranted or appropriate.

AIMA Canada believes that investors should be provided with all meaningful information which should be considered prior to making an investment decision. Specifically, if the changes to the Proposed Amendments suggested in this comment letter are alternative funds may have different timing for purchases, redemptions and risk methodologies which should be highlighted for investors. We suggest that it would be extremely helpful to industry participants if the CSA were to provide a pro forma alternative fund facts document for further consultation and comment prior to the final amendments coming into force.

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?

Response:

AIMA Canada believes that the Methodology should be consistent between conventional mutual funds and alternative funds. We also believe that fund

managers should have the ability to consider risk measures other than standard deviation as long as this is disclosed to the investor. We would recommend that the Methodology be revisited and adjusted in conjunction with the finalization of the Proposed Amendments as several elements of the Proposed Amendments will impact the overall risk profile of the fund.

There will likely be challenges for some alternative fund managers in complying with the new risk classification rules published in final form on December 8, 2016 and we recommend that some further consideration be given to how risk classifications will apply to alternative funds prior to the publication of the final amendments to NI 81-102 in order to ensure that alternative funds will be able to properly calculate and disclose risk to investors.

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.

Response:

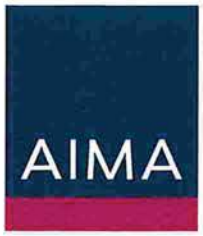
Although smaller investment managers may initially face challenges and increased expenses (compared to existing mutual fund managers) in meeting the requirements, AIMA Canada believes that the three month transition period set out in the Proposed Amendments should generally provide an adequate amount of time to implement a point of sale disclosure regime.

4. 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.

Response:

AIMA Canada supports the proposed transition period of three months from the final publication date for alternative funds. However, we note that some existing closed end funds and commodity pools that are adversely impacted by the changes to the investment restrictions in the Proposed Amendments may require more time to bring themselves into compliance with the restrictions (assuming that they are not grandfathered).



5. Other Comments on the Proposed Amendments

In addition to our Responses to the specific questions posed by the CSA, AIMA Canada has the following comments on other aspects of the Proposed Amendments.

Counterparty Exposure Limits (Section 2.7(4))

We do not agree with the elimination of the counterparty exposure exemption for alternative funds and non-redeemable investment funds. It is not clear that there is any risk from exposure to a single counterparty that needs to be mitigated.

The following comment has been made by others previously, including ISDA in their comment letter dated October 17, 2002 on proposed amendments to National Instrument 81-102 Mutual Funds and, in particular, on those aspects of NI 81-102 relating to swaps [available at: http://www.isda.org/speeches/pdf/osc-com-letter101702.pdf].

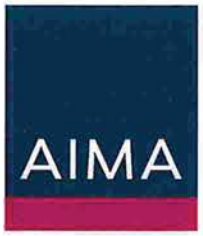
We submit that, under Section 2.7(4) of NI 81-102, the calculation of the mark-to-market value of the exposure of an investment fund to a counterparty should be net of credit support provided by the counterparty. This is because the provision of credit support eliminates the credit risk of the counterparty. 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.

Custodians of Alternative Funds (Part 6 of NI 81-102)

Under the Proposed Amendments, alternative funds would be required to appoint a custodian for the assets of the fund in the same manner as conventional mutual funds and custodians/sub-custodians of the assets of alternative funds would be required to adhere to the same requirements as custodians/sub-custodians of conventional mutual funds.

The operational reality for most alternative funds (arising from the frequency of trading, the amount of short selling conducted and the amount of borrowing and derivatives utilized by the fund) require the alternative fund to lodge the majority of its assets with one or more prime brokers. We submit that the proposal to require a separate custodian for the portfolio assets of an alternative fund does not provide any significant additional safeguards for the portfolio assets and would result in increased costs and operational complexities for alternative funds.

Prime brokers do not typically act as custodians for conventional mutual funds



for several reasons including: (i) the qualification requirements under Section 6.2 of NI 81-102; (ii) the prohibition on custodians taking security over portfolio assets of investment funds in Section 6.4(3)(a) of NI 81-102; (iii) the prohibition on the charging of fees for the transfer of beneficial ownership of portfolio assets in Section 6.4(3)(b) of NI 81-102; and (iv) the requirements relating the segregation of assets in Section 6.5 of NI 81-102.

In addition, although not a requirement, prime brokers can offer their clients the most efficient and cost-effective services if they are able to rehypothecate the non-segregated assets held in their client accounts. This has not generally been an issue for conventional mutual funds due to restrictions on leverage in NI 81-102, but for alternative funds that will be able to borrow and short sell up to 50% of NAV, permitting rehypothecation of collateral would significantly reduce transaction costs. This may also even the playing field somewhat between alternative fund managers and larger mutual fund companies who may be able to garner preferential terms from prime brokers if rehypothecation were not permitted.

In this regard, we submit that the portfolio assets of alternative funds will not be subject to any greater level of risk of loss. Prime brokers must adhere to the requirements of IIROC relating to the taking of security (margin) and the segregation of assets and the prime brokerage relationship is governed by the terms of the prime brokerage agreement We believe that in addition to the operational benefits and cost savings listed above there are sufficient safeguards in place to effectively protect client assets, specifically:

- Cash in a Prime Brokerage account is not segregated and may be used by the Prime Broker subject to limits set and monitored by IIROC. A Prime Broker is liable as a debtor to pay the alternative fund, as creditor, all such amounts.

- A Prime Broker holds all securities in its accounts for the alternative fund. In a cash account, all securities are fully paid for and are segregated (either in bulk with other client assets or specifically for an alternative fund if a bare trust agreement is entered into).

- In a margin account, alternative funds may borrow against portfolio securities to the extent of their margin value. The securities borrowed against, based on their margin value are not segregated by the prime broker. Short positions in the account that cannot be covered by available cash may also result in securities becoming un-segregated.

- Under IIROC rules, a prime broker may use only un-segregated securities in their business and only to the extent needed to cover a margin loan. For example, if a client has securities worth $1,000 in its Prime

Brokerage account and owe $100 on a margin loan, the Prime Broker would only be able to use securities having a total margin value of $100. Prime brokers use these securities in the normal course of their business.

- IIROC regulations require firms to review its segregation at the account level each day and to correct any deficiencies (IIROC Rules 2000.4 to 2000.6). A Prime Broker must take immediate action to correct any segregation deficiency (IIROC Rules 2000.8-9).

We note that, as part of amendments proposed for NI 31-103 in July of this year, the CSA contemplated that registered investment dealers who are members of IIROC would be permitted to act as custodians in Canada for the assets of privately offered investment funds.

AIMA Canada respectfully submits that registered dealers who are members of IIROC and who otherwise meet the qualification criteria to act as a Custodian under Section 6.2 of NI 81-102 (specifically, the criteria in Section 6.2.3 (a) and (b), requiring $10 million of equity or guarantee by the parent bank) should be permitted to act as the custodian or sub-custodian of an alternative fund. We also reiterate our comment relating to borrowing above that the requirement in Section 6.2(3)(a) of NI 81-102 that dealers' financial statements "have been made public" should be removed.

Permitting prime brokers of alternative funds to also act as custodian of the fund would save costs (by eliminating additional counterparties) and would not subject the portfolio assets of the alternative fund to any additional risk as prime brokers qualified to act as custodians will have sufficient capital and must act in accordance with IIROC rules and guidelines when taking and realizing on security or in connection with the segregation of assets.

Custodial Provisions relating to Short Sales (Section 6.8.1)

Section 6.8.1 of NI 81-102 currently permits a fund to deposit up to 10% of NAV with a borrowing agent, other than its custodian or sub-custodian, as security in connection with a short sale (the "10% of NAV Limit"). In practice, a borrowing agent generally requires that the proceeds from the short sale, plus additional collateral be held as security. Under the current NI 81-102 aggregate short sale restriction of 20% of a fund's NAV, this practice results in the need for at up to two or three dealers/borrowing agents to facilitate and permit a fund to short the maximum 20% of its NAV.

However, the Proposed Amendments will permit an alternative fund to short up to 50% of its NAV, without any change in the custodial provisions set out in Section 6.8.1 which presents both practical and operational issues for alternative funds. For example, under margin rules established by IIROC, an alternative fund entering into a short sale transaction for an equity security

eligible for reduced margin would be required to post 130% of the market value of the short position as margin (security). As a result, an alternative fund that wishes to take full advantage of the increased short sale limits (50% of NAV) would be required to deal with 7 separate borrowing agents (other than the custodian) in order to comply with the 10% of NAV Limit in Section 6.8.1. A similar situation would be experienced for other asset classes such as fixed income and FX forward transactions. This would not be practically feasible and would lead to operational and administrative inefficiencies and significantly increased costs for alternative funds including:

- the time and effort to evaluate and sign multiple prime brokerage/dealer arrangements will be significant and costly for alternative funds.
- Requirement for additional staff to manage daily operational activities such as margin, reconciliations, settlements and tax reporting
- greater costs from the fund administrator due to increased book-keeping and reconciliation requirements.
- smaller accounts would mean less leverage to negotiate favourable pricing and terms of service with prime brokers/dealers.
- the requirement to locate multiple suitable prime brokers may be challenging due to the size of the industry in Canada; and
- other solutions (such as the use of tri-party arrangements) that may allow an alternative fund to comply with the 10% of NAV requirement could be operationally challenging and add additional costs for the alternative fund.

We note that if prime brokers were permitted to act as custodians of alternative funds as we have suggested above, the current language in section 6.8.1 would function much more effectively. Notwithstanding this fact, we would submit that a 20% of NAV deposit limit with borrowing agents (other than the fund's custodian or sub-custodian) as security for short sales by alternative funds would provide alternative funds with the flexibility to engage the services of two or more prime brokers (other than their custodian or sub-custodian) in an effort to execute their investment strategies in a more efficient manner and to help alleviate potential counterparty risk.

Historical Performance Record (Part 15 of NI 81-102)

A number of AIMA members 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. Although, 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. Without this information, investors will not be able to obtain a complete picture of the skill of the alternative fund manager and the behaviour of the alternative strategies employed by the fund. AIMA Canada considers this information (with the relevant caveats) to be vital for investors who will not be familiar with this space.

Presentation of Financial Highlights in NI 81-106

We have the following specific comments relating to the presentation of financial highlights by mutual funds under NI 81-106.

Calculation of Management Expense Ratio and Trading Expense Ratios

We submit that due to the use of short selling and/or borrowing by alternative funds, the costs associated with such alternative investment strategies will significantly impact an alternative fund's expense ratio. As there is limited guidance on the inclusion of these expenses in either Management Expense Ratio ("MER") or Trading Expense Ratio ("TER"), we are concerned that there will be inconsistent treatment resulting in less comparability across different funds. Since these expenses, including dividend and interest expense on short sales and related short sale borrowing fees, as well as borrowing interest expense costs, are incurred in the course of execution of the alternative strategy, we recommend that the CSA provide guidance that confirms these expenses should be included as part of TER. Such treatment would be in line with other transaction costs which are currently included in TER, however it would treat interest expense on borrowing as TER rather than the current practice of including this expense as part of the MER. We submit that our recommended

treatment of these expenses for alternative funds would better align costs with the execution of the strategy (i.e. transactional in nature) rather than as an operating expense of the alternative fund.

Total return and total annual compound return calculations

NI 81-106 currently requires returns to be bifurcated and presented separately for long and short investments during the relevant period. We submit that the requirement to bifurcate long and short returns for alternative funds be removed as the current disclosure requirement would result in misleading information for investors both as it relates to fund performance as well as providing a complete understanding of the strategy and risk of the alternative fund. For example, various alternative strategies involve the execution of long-short "paired" trades or the use of short sales to hedge an element of market or interest rate risk such that the position is only relevant when one considers the combined long and short components. One must also take into account that specified derivatives are used by some alternative investment strategies instead of short sales to achieve a similar result. Thus, presentation of performance bifurcated between long and short positions will not allow an investor to understand the performance of the fund and will only promote misunderstanding and confusion.

Proficiency

We note that the CSA intends to engage with the Mutual Fund Dealers Association ("MFDA") in order to determine the appropriate proficiency requirements for dealing representatives of mutual fund dealers to distribute securities of alternative funds. AIMA Canada has a vast array of educational and other resources available relating to alternative investment strategies and we would be very pleased to offer our assistance to the CSA and MFDA in this regard.

Conclusion

We believe that the Proposed Amendments will usher in a new era and truly modernize Canadian investment fund product regulation. Once implemented, Canadian retail investors will have access under a prospectus for the first time to investment strategies and asset classes that can assist in both improving returns and mitigate market risk in an investment portfolio. AIMA Canada applauds the CSA for the reasoned and measured approach reflected in the Proposed Amendments. We feel that, with the additional changes suggested in our Comments and those anticipated from other market participants and stakeholders, alternative funds offered under NI 81-102 can play a meaningful role in helping Canadians realize their investment objectives.

We appreciate the opportunity to provide the CSA with our views on the

Proposed Amendments. Please do not hesitate to contact the members of AIMA set out below with any comments or questions that you might have.

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Yours truly,

ALTERNATIVE INVESTMENT MANAGEMENT ASSOCIATION

By:

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APPENDIX "A"
AIMA WHITE PAPER

Alternative Investment Management Association

AIMA WHITE PAPER

Comparing Measures of Leverage in Funds

September 2016

Introduction

There are currently several different methods of calculating leverage that are used in the fund management industry. The methods differ largely because they are used for different purposes. For many investors in alternative asset funds who want to compare leverage across funds in their portfolio and look for changes over time, for example, a more straightforward, easy-to-calculate measure may work best. For regulators concerned primarily with considering the potential impact of fund leverage on the stability of the financial system as a whole, the most relevant measure of leverage is likely to take into account current market conditions. This paper explains some of the main methods of calculating leverage that are used currently in various jurisdictions and discusses their differences, as well as their relative advantages and disadvantages.

What is leverage?

Leverage is generally thought to mean increasing financial exposure by borrowing funds to acquire assets, but for financial firms a more precise definition is necessary. In this context, leverage is any technique that is used by investors to try to create hedges against unwanted risks or to amplify gains. Leverage can be created by borrowing money or securities directly from counterparties (sometime called 'financial leverage') or indirectly by using derivative instruments such as options, futures or swaps (sometimes called 'synthetic leverage').[1]

Why leverage?

Leverage is frequently used by both public and private companies of all sizes, various governmental entities ranging from sovereign states to municipalities as well as a variety of other investor types, even individuals and families. In a corporate context, companies raise debt through a variety of channels to fund their working capital requirements, growth initiatives or expansion plans. Most governmental agencies around the world issue debt to fund operations, build infrastructure, and provide various public services. Families borrow to purchase large assets, like homes and cars.

In the asset management industry, leverage is often incorporated as part of an investment strategy in which borrowed money is used to adjust risk exposures with the intention of multiplying gains and/or limiting losses of an investment. In an investment context, portfolio managers can borrow money or assets to create a pool of capital larger than their initial equity obtained from investors to be used for adding more risk exposure with a goal to generate higher expected returns. Leverage can also be used to purchase hedges, instruments that protect against risks in a portfolio like an unexpected change in foreign exchange or interest rates. Leverage is used as a legitimate tool for asset managers and investors to help achieve their return goals as well as offset risk.

Measuring leverage of funds

Due to their different needs, investment managers, investors and regulators often employ different methodologies for measuring leverage. Leverage is usually calculated as a ratio of exposure/size of a portfolio of assets to the level of capital or equity that may support that. For funds, it is generally agreed that the fund's net asset value ('NAV'), which reflects the current value of the fund's investors' holdings, is the best estimate of capital or equity.

$$\text{Fund Leverage} = \frac{\text{Exposure/Size}}{\text{NAV}}$$

However, there are different methods of how to calculate exposure. These vary mainly by their approach to measuring off-balance sheet exposures obtained via the use of derivatives.

Balance sheet leverage takes into account a fund's assets compared with its equity. Where the entity's assets exceed its equity, under this method of calculating leverage, the fund would be leveraged. For example, if a fund had on-balance sheet assets worth £2 million and an NAV of £1

[1] See The Leverage Ratio, Katia D'Hulster, The World Bank (December 2009).

million, it would be employing 2x leverage under the balance sheet calculation method. In cases where the quality of the asset pool is broadly similar across entities, balance sheet leverage can be a useful proxy for relative riskiness because the greater the size of the assets, the greater the potential variability in their value. This is why balance sheet leverage is a useful metric for simple banking entities where the assets may be loans to corporations and mortgages. A shortcoming of balance sheet leverage as a risk measure is that is does not differentiate between asset portfolios of relative riskiness. For example, a portfolio of short-term U.S. government bonds is likely to be far less risky than a portfolio of emerging market equities of the same size.

As can be seen from the observations in the table below, classic financial statement based leverage definitions do not incorporate off-balance sheet positions (for example, derivatives). Incorporating derivatives into a leverage calculation requires consideration not only of the problem of relative riskiness (which applies for example to options and bonds of different durations) but also the issues of hedging (derivative positions which are highly negatively correlated with other risks in the portfolio and therefore reduce risk) and netting (long and short derivative positions which are virtually identical and have a very small net risk). These factors mean that derivative positions can both increase and decrease leverage, and therefore it is more useful to consider risk-based measures of leverage.

Risk-based measures of leverage are more complicated than the balance sheet measure of leverage, as they try to overcome the shortcomings of classic measures by relating a risk measure (for example, market risk when using value at risk ('VaR') measures) to a fund's capacity to absorb this risk (for example, the fund's equity). More sophisticated dynamic measures of leverage incorporate a fund's ability to adjust its risk position during periods of market stress.[2]

Regulatory measures of leverage

Regulators have invested considerable time in developing methods of measuring leverage, typically in order to analyse how much capital a bank or securities firm should be holding in light of the risks of their businesses. These methods take into account the risk that the value of the assets of the firm may fluctuate, which would necessitate the holding of higher capital levels, and the use of both borrowing and derivatives is incorporated into these analyses. In order to further analyse leverage arising from the use of derivatives, or synthetic leverage, many other methods may be used. These include the following:

(i) Gross methods

Gross methods generally take the sum of the absolute values of all long and short exposures, including those which are notional off-balance sheet exposures, and divide this by the fund's NAV. Most gross methods call for some calibration of the gross amount of derivatives, instead of using the face value of the contracts.

$$\text{Gross Leverage} = \frac{\text{long + short exposures (including off-balance sheet activities, e.g., borrowed securities and notional exposures of derivative contracts)}}{\text{NAV}}$$

The gross method used by the AIFMD

The Alternative Investment Fund Managers Directive ('AIFMD')[3] requires alternative investment fund managers ('AIFMs') to calculate leverage using both a gross method and a commitment method (see below). The gross method essentially adds to the balance sheet exposure measure all of the fund's off-balance sheet notional exposures gained via the use of derivatives without taking into account any netting or hedging of such absolute values.

[2] See Appendix E of the Hedge Fund Working Group's "Hedge Fund Standards: Final Report" (January 2008).

[3] Directive 2011/61/EU.

The gross method consists of calculating the absolute value of all positions of an AIF, as per the requirements for valuation. Initially this should include all short and long assets and liabilities, borrowings, derivatives (converted, as discussed above, into their equivalent underlying positions), repurchase and reverse repurchase agreements where the risks and rewards of the assets or liabilities are with the AIF and all other positions that make up the net asset value of the AIF.

Any cash and cash equivalent assets that are highly liquid and are held in the base currency of the AIF which provide no greater return than a three month high quality government bond are removed from the gross calculation because such assets are not deemed to increase exposure. This includes cash held for collateral by a counterparty. Any borrowing used to increase exposure should be excluded from the gross method calculation to avoid double counting. The exposure resulting from the reinvestment of cash borrowings should therefore be expressed as the higher of the market value of the investment realised or the total amount of the cash borrowed.

Gross method proposed by FSB/IOSCO: GNE

A variant of the gross method has also been contemplated as a useful measure both of size and leverage of the hedge fund industry in the most recent Financial Stability Board (FSB) and International Organization of Securities Commissions (IOSCO) consultation regarding the methodologies of identifying non-bank non-insurance systematically important financial institutions ('NBNI SIFIs'). This would take the absolute sum of all long and short positions, including gross notional value (delta-adjusted when applicable) for derivatives as its measure of exposure. This is called 'gross notional exposure' or 'GNE'. As noted by the UK Financial Conduct Authority:

> "this measure provides a complete appreciation of all the leverage that is employed by a fund to gain market exposure, i.e. financial leverage (repos, prime broker financing, secured and unsecured lending) and synthetic leverage (exposure through derivatives, including exposure to the underlying asset or reference). GNE does not directly represent an amount of money (or value) that is at risk of being lost. It is a reference figure used to calculate profits and losses."[4]

(ii) Commitment methods

Some risk based measures of leverage will attempt to measure the commitments of the entity. The AIFMD and the Undertaking for Collective Investment in Transferrable Securities ('UCITS') legislation both set out ways to calculate commitment measures of leverage.

The commitment method used by the AIFMD

The AIFMD not only requires that a fund's leverage be calculated using the gross method, but also mandates that a commitment method is used. The commitment method calculates the exposure of an AIF by taking the sum of the absolute values of all positions. Further detailed criteria are set out in paragraphs 2-9 of Article 8 of the AIFMD Level 2 Regulation.[5] The commitment method allows for the netting of exposures (which is not permitted under the gross method) as well as a limited recognition of hedging to decrease the exposure measure of the leverage ratio. Furthermore, the commitment method requires the notional amounts of interest rate derivative contracts to be adjusted to the fund's "target duration". However, it should be noted that the conditions for netting and hedging are opaque and that some arrangements that a manager employs for hedging purposes may not qualify.

Derivatives can be removed from the calculation if they swap the performance of assets held by the AIF for other reference financial assets or offset the market risk of the swapped assets held in the AIF so the performance of the AIF does not depend on the swapped assets. In these cases the derivatives are removed from the calculation because they reduce the exposure of the AIF.

[4] http://www.fca.org.uk/static/documents/hedge-fund-survey.pdf.

[5] Commission delegated regulation No 231/2013.

The commitment approach used by the UCITS legislation

A UCITS may elect to use either: (i) the commitment approach for measuring global exposure and leverage; or (ii) an advanced risk measurement technique (e.g., VaR (see below)). Detailed methodologies to be followed by UCITS when they use the commitment or the VaR approach have been developed by the Committee of European Securities Regulators (CESR), the predecessor to the European Securities and Markets Authority (ESMA). In these guidelines, CESR states that: "It is the responsibility of the UCITS to select an appropriate methodology to calculate global exposure. More specifically, the selection should be based on the self-assessment by the UCITS of its risk profile resulting from its investment policy (including its use of financial derivative instruments)."

CESR's guidelines state that the commitment approach is appropriate for a UCITS that does not use complex derivatives or trade derivatives extensively.[6] This approach is based on the market value of the asset underlying the derivative and sums up the aggregate absolute value of the underlying exposures' notional values. For a UCITS using the commitment approach, derivatives are converted into their equivalent position in underlying assets. The exposure is then calculated following netting.

Using the commitment approach to measure global exposure, financial derivatives instrument ('FDI') exposure is measured as the positive market value of the equivalent underlying position.

FDI and security positions may be netted to reduce global exposure as follows:

- Between FDI, provided they refer to the same underlying asset, even if the maturity dates of the FDI are different; and
- Between FDI (whose underlying asset is a transferable security, money market instrument or a collective investment undertaking) and the same corresponding underlying asset.[7]

Hedging arrangements may only be taken into account when the following criteria are satisfied:

- Investment strategies that aim to generate a return should not be considered as hedging;
- There must be a verifiable reduction of risk at the UCITS level;
- The risks linked to the FDI should be offset;
- They should relate to the same asset class; and
- They should be efficient in all market conditions.

The calculation of global exposure is always presented as an absolute positive number and does not allow for the calculation of negative commitments. This calculation is used to limit overall leverage in UCITS funds so that the exposure may not exceed the NAV of the UCITS.

(iii) VaR methods

Another calculation methodology that may be used under the UCITS legislation to calculate a UCITS's global exposure, where appropriate, is one which utilises VaR. The VaR approach is a measure of the maximum potential loss due to market risk, which measures the maximum potential loss at a given confidence level (probability) over a specific time period under normal market conditions.

For example if the VaR (1 day, 99%) of a fund is £2 million, this means that, under normal market conditions, the fund can be 99% confident that a change in the value of its portfolio would not result in a decrease of more than £2 million in one day. This is also equivalent to saying that there is a 1% probability (confidence level) that the value of its portfolio could decrease by £2 million or more during one day, but the level of this amount is not specified and could be far greater than £2 million.

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[6] See CESR's Guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS.
[7] Id., at box 2.

The VaR approach can be further subdivided into (i) an absolute and (ii) a relative VaR approach. The maximum absolute VaR limit is set at 20% of the NAV over a 20-day holding period and based on a 99% confidence interval[8]. The relative VaR limit is twice the VaR of a derivative free benchmark.

A UCITS using the VaR may use absolute VaR or relative VaR. A proper VaR limit should be assigned (which is not necessarily the one allowed by regulation) where the risk/reward indicator will be at its highest level. Another set of CESR guidelines,[9] state that for absolute return funds, the VaR should be calculated using volatility determined by the maximum of historical volatility and the risk limit. If there is not enough historical data to compute the VaR, then it is calculated only by using the risk limit.[10]

Relative VaR is the VaR of a UCITS divided by the VaR of a UCITS reference portfolio. Relative VaR cannot exceed 200% or two times the VaR on a comparable benchmark portfolio or derivatives-free portfolio.

The VaR model must comply with the following requirements:

- The confidence level (one tailed) must be 99%;
- The maximum holding period is 20 days;
- The minimum historical holding period is one year;
- Stress tests should be performed monthly; and
- Back-testing should be performed monthly.

The VaR model may use a different confidence level and/or holding period, provided the confidence interval is not below 95% and the holding period does not exceed 20 days. In such instances, the VaR limit may be adjusted accordingly.

For any UCITS using the VaR approach to calculate its global exposure, ESMA also requires the UCITS to use the so-called "sum of notionals" method to calculate its leverage for disclosure purposes.[11] The sum of notionals method adds together all notional amounts of any derivative positions without using any netting or hedging. This method, which is similar to the gross method under AIFMD in that it provides valuation of derivatives, has the benefit of providing a common comparative standard amongst various funds, though clearly its applicability across different strategies may vary significantly.

(iv) Leverage calculation methodologies used by 1940 Act funds

With respect to leverage, the U.S. regulatory regime imposes implicit limits on leverage via the Section 18(f)(1) of the Investment Company Act of 1940 (the '1940 Act'), which generally prohibits registered open-end investment companies from issuing "senior securities". Broadly speaking, a "senior security" is any security or obligation that creates a priority over any other class to a distribution of assets or payment of a dividend. Permissible "senior securities" include, among other things, a borrowing from a bank where the fund maintains an asset coverage ratio of at least 300% while the borrowing is outstanding. This is referred to as the 300% asset coverage requirement. For instance, a 1940 Act fund with $100 million in assets may borrow up to $50 million from a bank. Following the borrowing, the 1940 Act fund would have $150 million of assets and $50 million of borrowing and would therefore satisfy the 300% asset coverage requirement. However it is

[8] See CESR's Guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS, at box 15.

[9] CESR's guidelines on the methodology for the calculation of the synthetic risk and reward indicator in the Key Investor Information Document.

[10] See CESR's Guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS, at box 5.

[11] See Questions 2 of ESMA's Questions and Answers on Risk Measurement and Calculation of Global Exposure and Counterparty Risk for UCITS.

important to note that, under the current rules (which are proposed to be changed),[12] 1940 Act funds can potentially use some forms of leverage without requiring a 300% coverage ratio by using levered investment vehicles. In particular, cash-settled derivative contracts can be used almost without limit.

The U.S. Securities and Exchange Commission (SEC) currently limits use of leverage from short sales and derivative instruments by prohibiting complex capital structures in 1940 Act funds and the issuance of "senior securities" as defined in Section 18 of the 1940 Act. The SEC has deemed that leverage may exist when "an investor achieves the right to a return on a capital base that exceeds the investment which he has personally contributed to the entity or instrument achieving a return."[13] The types of transactions explicitly identified by the SEC as potentially creating "senior securities under Section 18 include reverse repurchase agreements, written options, futures and options on futures, forward contracts on currencies or securities, firm commitment agreements, standby agreements, and short sales. Specifically, derivatives transactions that may create "senior" securities are writing call futures, writing call options or entering into swaps, because each such transaction obligates the fund to deliver a security or make a payment in the future.

To comply with Section 18(f) of the 1940 Act, a fund must "cover" the obligation (indebtedness) created by a "senior security" transaction with cash and/or liquid securities in the fund's portfolio, provided the "cover" assets are placed in a segregated account at the custodian. Alternatively, the fund may enter into a directly offsetting transaction. Current SEC guidance permits two types of segregation: "notional" and "mark-to-market." Futures, forwards, options and short sale contracts that on expiry require physical settlement (i.e., the delivery of the underlying security) must be "covered" by segregating the full notional amount (i.e., the full value of the potential obligation of the fund under the contract) or by entering into certain offsetting transactions. However, where the contracts are cash settled (i.e., on expiry there is no delivery of the underlying security but rather a cash payment of the net value), the "cover" requirement is limited to the fund's daily marked-to-market obligation, i.e., the daily difference between the fund's obligation to its counterparty and the counterparty's obligation to the fund.

In a 1987 no-action letter,[14] the SEC's Division of Investment Management clarified that covering a derivatives position with an offsetting position effectively eliminates the derivatives exposure and obviates the need to segregate assets to comply with the 300% asset coverage requirement. The SEC stated that a fund that has purchased a futures or forward contract can cover that position by purchasing a put option on the same futures or forward contract with a strike price equal to or higher than the futures or forward contract price. The no-action letter also provided that a fund that has sold a put option could cover its position by selling short the instrument or currency underlying the put option at the same or a higher price than the strike price of the original put.

While the requirements for segregation and offsets are quite complex and derived from years of interpretative positions, the table below gives at least a flavour of what is involved.

Types of Transactions	Segregation Requirement
Forward Currency Contracts	For physically settled long positions, the fund must segregate the gross settlement amount. For physically settled short positions, the fund must segregate the market value of the foreign currency that the fund has sold, marked to market daily. For cash settled long or short positions, the fund must, segregate the net settlement amount, marked to market daily. In all cases, however, the amount that the fund must segregate can be reduced in some specific circumstances if the fund has posted margin or collateral against its obligations (posting collateral is the equivalent of segregating assets) and the fund has "covered" its obligation.

[12] See Use of Derivatives by Registered Investment Companies and Business Development Companies, Investment Company Release No. IC-31933 (11 Dec. 2015).

[13] See Investment Company Act Release No. 10666 (Apr. 18, 1979) 17 SEC Docket 319.

[14] See https://www.sec.gov/divisions/investment/imseniorsecurities/dreyfusstrategic033087.pdf.

Types of Transactions	Segregation Requirement
Purchased Options	None. Since the fund has no obligation to exercise the option, it has no payment or delivery obligation against which it must segregate any assets.
Long Futures Positions and Long Written Options Purchase of Futures Contract and sale of Put Option	The fund must segregate the amount of the purchase price that the fund will be required to pay on the settlement date for the futures contract or on the date that the put option is exercised. This may be limited to the net amount that fund would be required to pay if the position is cash settled. The amount that the fund must segregate is reduced by the amount of any initial or variation margin (or other collateral) that has been deposited posted with an FCM, broker or the counterparty; and to the extent that the fund has "covered" its position.
Short Futures Positions and Short Written Options Sale of Futures Contracts or Call Options	The fund must segregate an amount equal the current market value, marked to market daily, of the security (or index, instrument, etc.) underlying the contract. This may be limited to the net amount that fund would be required to pay if the position is cash settled. The amount that the fund must segregate is reduced by the amount of any initial or variation margin (or other collateral) that has been deposited posted with an FCM, broker or the counterparty; and to the extent that the fund has "covered" its position.
Spreads and Straddles	If proceeds of one leg of the transaction can be used to satisfy all or part of the fund's obligation under the other leg, the fund only needs to segregate an amount equal to its obligations (marked to market daily) under the prong providing the larger potential exposure - *e.g.*, the written put option in a straddle, where the fund writes both a put and a call option on the same security.
Swaps (Other than Credit Default Swaps)	For fully cash-settled swaps, the fund must segregate the "fund out of the money amount", marked to market daily, plus the amount of any accrued but unpaid premiums or similar periodic payments, net of any accrued but unpaid periodic payment payable by the counterparty. The amount that must be segregated is reduced to the extent that the fund has posted collateral against its obligations under the swap. Special considerations apply to credit default swaps though.
Reverse Repurchase Agreements	The fund must segregate an amount equal to the repurchase price, marked to market daily.
Short Sales	The fund must segregate an amount equal to the current market value of the securities sold short. The amount that must be segregated is reduced to the extent that the fund has posted collateral - other than the proceeds of the short sale - against its obligations with respect to the short sale position. The proceeds of the short sale are not counted for purposes of satisfying a fund's segregation requirements.

(v) Leverage calculation methodologies used by banks

The Basel Committee on Banking Supervision (BCBS) introduced the Basel III leverage ratio in order to create "a simple, transparent, non-risk based leverage ratio to act as a credible supplementary measure to the risk-based capital requirements."[15] In its paper entitled 'Basel III leverage ratio framework and disclosure requirements' the BCBS stated that in their view "a simple leverage ratio framework is critical and complementary to the risk-based capital framework; and a credible

[15] See http://www.bis.org/publ/bcbs270.pdf.

leverage ratio is one that ensures broad and adequate capture of both the on- and off-balance sheet sources of banks' leverage." [16]

The Basel III leverage ratio is defined as the capital measure (the numerator) divided by the exposure measure (the denominator), with this ratio expressed as a percentage:

Leverage ratio = capital measure/exposure measure

The capital measure used for the leverage ratio at any particular point in time is the Tier 1 capital measure applying at that time under the risk-based framework.[17] In order to calculate the exposure measure, at present banks generally adopt the Current Exposure Method (CEM) to capture off-balance sheet derivatives exposures, including centrally cleared derivatives exposures. The exposure measure for the leverage ratio should generally follow the accounting value, subject to (i) on-balance sheet, non-derivative exposures are included in the exposure measure net of specific provisions or accounting valuation adjustments (e.g., accounting credit valuation adjustments); and (ii) netting of loans and deposits is not allowed. A bank's total exposure measure is the sum of the following exposures: (a) on-balance sheet exposures; (b) derivative exposures; (c) securities financing transaction exposures; and (d) off-balance sheet items.[18] The CEM takes the sum of the gross assets held by the fund and the adjusted GNE whereby the different derivatives asset classes are weighted by the factors indicated in Table 1 below.

Table 1: Risk weighted factors = from the table and we have applied the most conservative factor in each case.

Remaining Maturity	Int Rate	FX rate & Gold	Credit (Investment Grade)	Credit (non-investment grade)	Equity	Precious Metals (except Gold)	Other
<=1 year	0	0.01	0.05	0.1	0.06	0.07	0.1
>1 yr and <= 5 yrs	0.005	0.05	0.05	0.1	0.08	0.07	0.12
>5 yrs	0.015	0.075	0.05	0.1	0.1	0.08	0.15

Source: ConverSource conversion factor matrix for OTC derivative contracts for Basel III (Basel Capital Market Risk Final Rule)

The CEM recognises legally enforceable netting arrangements and takes into account the potential future volatility in the market value of the underlying asset and the remaining maturity of derivative contracts. CEM is a more accurate representation of risk than straightforward leverage. However, the CEM has been criticised for several limitations, in particular that it does not differentiate between margined and unmargined transactions, that the supervisory add-on factor does not sufficiently capture the level of volatilities as observed over recent stress periods, and the recognition of netting benefits is too simplistic and not reflective of economically meaningful relationships between derivatives positions.

The CEM method will therefore be replaced by an updated method, the Standardised Approach (SA-CCR), in January 2017.[19] The SA-CCR is a method for measuring exposure at default (EAD) for counterparty credit risk (CCR) and will be used by banks in the exposure component of the 'leverage ratio' in place of the CEM. The SA-CCR provides even greater recognition of hedging and netting benefits than the CEM and differentiates between margined and unmargined trades.

[16] Id.

[17] See the Tier 1 capital of the risk-based capital framework as defined in paragraphs 49 to 96 of the Basel III framework at http://www.bis.org/publ/bcbs128.pdf and see http://www.bis.org/publ/bcbs270.pdf.

[18] See further http://www.bis.org/publ/bcbs270.pdf.

[19] See http://www.bis.org/publ/bcbs279.pdf, which explains the SA-CCR in detail.

It is worth noting that the ten largest banks in the world have an average balance sheet leverage (ratio of assets to equity) of approximately 20x but the highest derivatives leverage (ratio of derivatives gross notional to equity) exceeds 1000x even taking into account the available netting and other reductions of gross notionals permitted under the CEM. If bank leverage were measured on a gross notional exposure basis, as has been suggested for hedge funds by the IOSCO-FSB consultation papers (and as implemented under the AIFMD), that figure would be substantially higher.

(vi) Major Swap Participants

Historically, when people have looked at systemic importance or relative importance of certain entities within the derivatives market place, they have not used simple measures of leverage for making such determinations. One such example can be seen in the calculation methodologies in place for determining whether an entity qualifies as a major swap participant ('MSP') in one or more derivatives markets. The approach taken when assessing whether an entity is a MSP is akin to the Basel III approach to assessing derivatives holdings in as much as certain netting and discount factors are applied before reaching a relevant figure.

The Dodd-Frank Wall Street Reform and Consumer Protection Act (the 'Dodd-Frank Act') introduced a requirement that all MSPs must register with the Commodity Futures Trading Commission (CFTC). The CFTC and the SEC adopted a final rule defining, "major swap participant" as a person, other than a swap dealer, that meets any of the following three tests:

- it maintains a "substantial position" in any of the major swap categories, excluding positions held for hedging or mitigating commercial risk and positions maintained by certain employee benefit plans for hedging or mitigating risks in the operation of the plan;
- it has "substantial counterparty exposure that could have serious adverse effects on the financial stability of the U.S. Banking system or financial markets"; or
- a "financial entity" that is "highly leveraged [12 to 1] relative to the amount of capital such entity holds and that is not subject to capital requirements established by an appropriate Federal banking agency" and that maintains a "substantial position" in any of the major swap categories.

A position is a "substantial position" if it satisfies either the "uncollateralized exposure test" or the "potential future exposure test" and each of these tests apply to a person's swap positions in each of four major swap categories:

- rate swaps (any swap based on reference rates such as interest rates or currency exchange rates);
- credit swaps (any swap based on instruments of indebtedness or related indices);
- equity swaps (any swap based on equities or equity indices); and
- other commodity swaps (any swap not included in the first three categories, including any swap based on physical commodities).

The uncollateralized exposure test measures a person's current uncollateralized exposure by marking the swap positions to market using industry standard practices. This test also allows the deduction of the value of collateral that is posted with respect to the swap positions, and calculates exposure on a net basis, according to the terms of any master netting agreement that applies. The thresholds adopted for this test are the daily average current uncollateralized exposure of US$1 billion in the applicable major category of swaps, except that the threshold for the rate swap category would be US$3 billion.

The second substantial position test determines potential future exposure by:

(i) multiplying the total notional principal amount of the person's swap positions by specified risk factor percentages (ranging from ½% to 15%) based on the type of swap and the duration of the position;

(ii) discounting the amount of positions subject to master netting agreements by a factor ranging between zero and 60%, depending on the effects of the agreement; and

(iii) if the swaps are cleared, further discounting the amount of the positions by 90% or, if the swaps are not cleared but nonetheless subject to daily mark-to-market margining, further discounting the amount of the positions by 80%.

The thresholds adopted for the second test are US$2 billion in daily average current uncollateralized exposure plus potential future exposure in the applicable major swap category, except that the threshold for the rate swap category would be US$6 billion.

Substantial counterparty exposure is calculated using the same method used to calculate substantial position but it is not limited to the major categories of swaps and does not exclude hedging or employee benefit plan positions. The thresholds as adopted for substantial counterparty exposure are a current uncollateralized exposure of US$5 billion, or a sum of current uncollateralized exposure and potential future exposure of US$8 billion, across the entirety of a person's swap positions.

An alternative to measures of leverage such as the gross methods would be to use the methodology for identifying MSPs as an initial threshold. This methodology also has the benefit of being more akin to the Basel III approach to assessing derivatives holdings in as much as certain netting and discount factors are applied before reaching a relevant figure.

Evaluating different regulatory measures of leverage

(i) Problems with gross measure of leverage

AIMA considers that the use of GNE as defined by FSB and IOSCO or any of the variants of the gross method is not particularly useful for funds or other financial entities, managers and investors monitoring risk or regulators looking to assess and monitor systemic risk for the following reasons:

- **Offsetting of risk:** The gross methods do not allow for the offsetting of positions that might decrease or eliminate risk in a portfolio. These leverage measures generally include all positions, even those that offset risks arising from a fund's investment portfolio. For example, these methods count the full notional value of a swap that offsets currency or interest rate risk of an equity or debt position held by a fund, despite the swap serving to decrease the exposure of the fund. Similarly, they would count twice the full notional values of two perfectly offsetting positions, even though the fund's net economic exposure would be zero;
- **Relative risk of different types of derivatives:** The gross methods do not account for the relative risk of different types of derivatives positions held by a fund. For example, in related contexts global regulators have consistently recognised that derivatives referencing short-term interest rates are less risky, given a particular amount of notional exposure, than those referencing long-term interest rates or other asset classes such as currencies, equities or commodities;
- **Nature of the risks of options:** The gross methods do not take account of the non-linear nature of the risks arising from options and other similar derivative positions. A fund whose derivative positions consist only of purchased options may have a high gross leverage, but the maximum possible loss is the current value of the options, a figure that may be orders of magnitude lower than the notional. For example, a one-month at-the-money call option on the S&P 500 index currently has a value of approximately 1% of its notional amount, so the notional is 100x greater than the maximum possible loss; and
- **The gross methods over-weight the risk of interest rate, currency or other types of derivatives relative to other assets:** The notional, or face, amounts of such contracts (rather than their market values) are required to be included in the calculations. This particularly

affects managers employing relative value, macro and managed futures strategies. Funds using these types of instruments generate leverage figures under the gross method that are not necessarily reflective of the risk of those funds. The market value or the cost to close out these contracts is a small fraction of the notional. These factors pose difficulties both for supervisory authorities when seeking to assess the build-up of systemic risk in the financial system and for investors in terms of making meaningful comparisons between different funds.

(ii) Problems with the commitment method

The commitment method addresses some of the issues inherent in the gross method through the application of netting and hedging arrangements and the use of duration netting rules. Although this is an improvement on the gross method, the commitment method still has limitations, which include the following:

- **Intention at the time of the trade:** Under the AIFMD commitment method, netting is only permitted where "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."[20] This is therefore dependent on the intention at the time of the trade, which is a subjective test. There has been no further guidance as to how this intention can be ascertained and determining when netting is permitted is therefore a matter of interpretation for each AIFM, which gives rise to uncertainty. It is therefore unclear what the conditions for permitted netting are;
- **Potential for excessive netting:** The commitment method also provides that netting is permitted across derivatives "which refer to the same underlying asset... irrespective of the maturity date". This would therefore permit the netting of a very long term interest rate derivative (for example, a 30-year swap) with a short term interest rate derivative (for example, a 2-year swap), or a long-dated commodity derivative (for example, natural gas futures with 5-year maturity) with a short-dated commodity derivative (for example, Natural Gas futures for December 2014 maturity), in both cases leaving an exposure of zero. This leaves the potential for excessive netting which may mask real exposures;
- **Application of duration netting rules:** The AIFMD commitment method permits "duration netting" under certain conditions. Article 8(9) of the Level 2 Regulation provides that "AIFMs managing AIFs that, in accordance with their core investment policy, primarily invest in interest rate derivatives shall make use of specific duration netting rules in order to take into account the correlation between the maturity segments of the interest rate curve as set out in Article 11." In relation to this provision, Article 11 provides that:

  > "The duration-netting rules shall not be used where they would lead to a misrepresentation of the risk profile of the AIF. AIFMs availing themselves of those netting rules shall not include other sources of risk such as volatility in their interest rate strategy. Consequently, interest rate arbitrage strategies shall not apply those netting rules... The use of those duration-netting rules shall not generate any unjustified level of leverage through investment in short-term positions. Short-dated interest rate derivatives shall not be the main source of performance for an AIF with medium duration which uses the duration netting rules."

  These tests lack clarity and determining whether duration netting rules may be applied, absent further guidance, is therefore a matter of interpretation for each AIFM, which gives rise to uncertainty; and
- **Maturity range buckets:** It may also be possible for the duration netting rules to lead to excessive netting. The duration netting rules specify that interest rate derivatives should be allocated to one of four maturity range buckets: 0-2 years, 2-7 years, 7-15 years and >15 years. Within each bucket, 100% offset is allowed. This means that under these rules, for example, a 2-year swap can be netted with a 7-year swap, leaving an exposure of zero. This leaves

[20] See Article 8(3)(a) of the Level 2 Regulation.

potential for excessive duration netting and can mask real exposures. The use of the four maturity range buckets and the offset percentages is also an arbitrary choice and bears no relation to risk measurement. For example, a 2-year vs 7-year offset will be fully netted, while a 1.9-year vs 7.1-year offset will only be netted 25%, despite these spreads having almost identical risk.

(iii) Problems with the VaR method

Whereas the commitment and gross approaches principally focus on derivatives, the VaR method's principal focus is the total market risk level of the portfolio. The use of the commitment approach for market risk computation in the context of UCITS funds has clearly been imposed to limit the leverage opportunities as the commitment approach converts any derivative exposures into fully funded values.

By contrast, VaR provides the estimation of the maximum loss a portfolio will suffer during a defined future period with a defined confidence interval. The VaR computation needs to be considered as an indicator. It is most useful in evaluating portfolios of more liquid instruments and derivatives where there is ready and accurate pricing data and history. However, VaR is less useful for illiquid instruments with little price data. On the ends of the liquidity spectrum, VaR is a good measure for an equity-fund focused on large cap stocks, but relatively useless for a real estate fund and it should not be considered a guarantee of limited losses.

Although VaR can be a useful metric for certain types of investment funds, under certain types of market conditions, it is not a useful metric for all funds nor for highly stressed market conditions. The VaR approach utilises correlations which have a propensity to break down in stressed market conditions and so there may be a tendency for the calculation methodology not to work in the very conditions where a robust leverage figure may be most valuable to competent authorities and investors.[21] VaR measures are also reliant on historical data.

Under the right circumstances, VaR can be a strong and advanced indicator that will (as long as tools and models are properly implemented) give clear and easy to interpret information to the risk managers and any related parties of the current portfolio risk levels.

Which methodologies are most suitable for funds?

In this paper, AIMA has sought to demonstrate the problems with the current methodologies that are used for calculating leverage in the asset management sector for regulatory purposes. We consider that more accurate, consistent and comparable methodologies should be used to measure the leverage employed by financial institutions.

Irrespective of the approaches chosen, the most important elements of any appropriate leverage measure should include the differentiation between the types of different derivatives instruments based on the manner notional exposure translates into a real economic exposure by a fund. Such a measure will recognise the fact that notional exposure means different things for different derivatives. It will also need to take appropriate account of netting and offsetting exposures. Neither one of these two core elements are present in any of the varieties of gross measures of leverage which either exist in some national regulatory regimes or have been contemplated at the global level.

In conclusion, we would like to reiterate that there is no single measure of leverage which would represent the most appropriate measure of risk for the purposes of investor disclosure or financial stability for all types of funds or all types of investment strategies. Indeed, leverage is not necessarily correlated or to be equated with a risk a particular portfolio may represent.

[21] See ESMA's consultation paper on draft technical advice to the European Commission on possible implementing measures of the Alternative Investment Fund Managers Directive: http://www.esma.europa.eu/system/files/2011_209.pdf.

PMAC
PORTFOLIO MANAGEMENT ASSOCIATION OF CANADA
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December 22, 2016

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 Consumer 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

comments@osc.gov.on.ca and consultation-en-cours@lautorite.qc.ca

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

The Portfolio Management Association of Canada ("**PMAC**"), through its Industry, Regulation & Tax Committee, is pleased to have the opportunity to provide comments on the Canadian Securities Administrators' ("**CSA**") Notice and Request for Comment – Modernization of Investment Fund Product Regulation – Alternative Funds (the "**Proposed Amendments**").

Capitalized terms used in this letter but not defined herein have the same meaning given to them in the Proposed Amendments.

Overview

PMAC represents investment management firms registered to do business in Canada as portfolio managers. PMAC members encompass both large and small firms managing total assets in excess of $1.5 trillion for institutional and private client portfolios[1]. We advocate for the highest standards of unbiased portfolio management in the interest of the investors served by our members.

PMAC is appreciative of the CSA's innovative, thoughtful and ongoing policy work to modernize investment fund product regulation (the "**Modernization Project**") in a way that focuses on

[1] Many of PMAC's members are also registered as investment fund managers that offer a variety of investment products to institutional investors and private clients. For more information about PMAC and our mandate, please visit our website at: www.portfoliomanagement.org.

investor protection while reflecting the significant expansion of investment fund products and strategies available in the market.

We believe that the CSA's approach to the Modernization Project has been constructive and we are appreciative of the proposed new framework that seeks consistency and fairness in the regulatory approach for all investment funds while, at the same time, providing flexibility and investor access to alternative investment strategies that are already available in the exempt market to help individual investors diversify their portfolios and achieve their savings goals.

In a low interest rate environment with unpredictable markets, Canadian investors are seeking to diversify their investments and access higher returns in order to realize their investment objectives. PMAC believes that the enhanced ability to offer diverse funds and strategies that can mitigate risk, take advantage of market inefficiencies or help seek more consistent returns during volatile market conditions can help to maintain investor protection and place Canada more competitively in the rapidly innovating global markets.

PMAC welcomes the comprehensive framework for investment funds set out in the Proposed Amendments. We applaud the CSA's efforts to streamline securities instruments by creating a single, foundational framework applicable to all funds through the repeal of National Instrument 81-104 – *Commodity Pools*, bringing these "alternative funds" under National Instrument 81-102 – *Investment Funds* ("**NI 81-102**"). We believe that this simplification and consolidation of requirements and restrictions is beneficial in terms of consistency, clarity and transparency.

The extent and quality of the debate that PMAC members engaged in on the various consultation topics speaks to the complexity and importance of the alternative funds framework. PMAC members have raised a few matters on which we seek clarification as well as comments for the CSA's consideration on certain aspects of the Proposed Amendments, as further set out below.

Investment Restrictions

Asset Classes

There was a fair amount of debate among members regarding asset classes that are common under typical alternative investment strategies and warrant consideration for inclusion as "alternative funds" under the Proposed Amendments. Certain members, including those with niche expertise and market offerings, will be making their own submissions in support of additional asset classes and strategies used by alternative funds in the exempt market for consideration by the CSA.

Illiquid Assets

As part of the Modernization Project, it may be useful to revisit the definition of "illiquid asset" in NI 81-102. Currently, an illiquid asset is a "portfolio asset that cannot be readily disposed of through market facilities on which public quotations in common use are widely available at an amount that at least approximates the amount at which the portfolio asset is valued in calculating the net asset value per security of the mutual fund". PMAC believes the definition should be updated to reflect that securities that trade in over-the-counter ("**OTC**") markets are not "illiquid assets", provided that they are actively traded on such OTC markets. We believe this would be a welcome clarification and modernization of the definition to reflect current practices.

We believe that the addition of the following underlined wording in the definition of "illiquid asset" would be beneficial:

> "illiquid asset" means:

(a) a portfolio asset that cannot be readily disposed of through market facilities on which public quotations in common use are widely available (which include over-the-counter-markets) at an amount that at least approximates the amount at which the portfolio asset is valued in calculating the net asset value per security of the investment fund or

(b) a restricted security (other than a government or corporate bond) held by an investment fund;

The CSA is soliciting feedback regarding the cap on the amount of illiquid assets held by a fund and with respect to securities being redeemable at net asset value ("**NAV**") once a year.

We note there is a discrepancy between the Proposed Amendments regarding purchases and redemptions for alternative funds and the NAV calculation requirements. While many conventional mutual funds calculate NAV on a daily basis, many hedge funds calculate NAV on a weekly basis – unless they short sell or use specified derivatives in which case the requirement is for a daily NAV calculation (as a result of Section 14.2(3) of National Instrument 81-106 – *Investment Fund Continuous Disclosure*). Under 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, therefore, if a mutual fund (which under the Proposed Amendments would include an alternative fund) is required to calculate NAV on a daily basis, this could create difficulties for funds redeemable on a weekly or monthly basis.

PMAC notes the carve-out available for alternative funds allowing for the redemption price to be the NAV determined on the first or second business day after the fund receives an order for redemption, but this carve-out does not fully address the logistical challenges that certain alternative funds may face.

NAV calculations associated with purchases will also pose a similar problem for alternative funds 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 the fund has received an order for purchase and there is no similar first or second business day carve-out from this requirement.

While we note that the Proposed Amendments do not prescribe any particular redemption frequency for alternative funds, there are problems with the amendments, as proposed, for alternative funds offering weekly or monthly purchases and redemptions ("**Dealing Days**"). Such funds will need to use multiple issue and redemption prices on any particular single Dealing Day because they will be calculating their NAV on a daily basis and can potentially receive orders every day of the week.

If not corrected, the mismatching of the issue and redemption prices with the NAV on the particular Dealing Day could result in significant operational inefficiency and confusion.

One suggested solution would be to revise Section 10.3(5) of the Proposed Amendments to NI 81-102 in the following way:

(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 ~~first or 2nd business day~~ after the date of receipt by the alternative fund of the redemption order.

A corresponding provision should also be added to Section 9.3 of NI 81-102 to address purchases so that the purchase terms for alternative fund securities is consistent with the redemption terms.

PMAC believes that alternative funds should be required to describe their purchase and redemption procedures, including information about purchase and redemption frequency, in their simplified prospectus disclosure.

Borrowing, the Use of Prime Brokers and Short Selling

PMAC supports the flexibility in the Proposed Amendments for alternative funds to borrow up to 50% of their NAV in order to facilitate a wider array of investment strategies than would have otherwise been available, subject to the comments raised below.

A concern raised by members is that the Proposed Amendments restrict funds to borrowing only from entities that qualify as investment fund custodians under Section 6.2 of NI 81-102. As the CSA notes, this restricts borrowing to banks and trust companies in Canada and to a limited subset of their dealer affiliates. The ability to borrow from foreign lenders is, however, important to many alternative funds. For example, certain funds that buy U.S. securities borrow from U.S. Schedule 1 banks to increase efficiency in dealing with the same currency. NI 81-102 has provisions allowing for the recognition of foreign custodians (which include elevated standards) and PMAC believes that a similar framework to allow for foreign lenders would be useful. There is a concern that limiting borrowing only to Canadian financial institutions would reduce competition and potentially also increase borrowing costs since Canadian lenders may charge higher rates for U.S. dollar loans than an American lender. There is also a concern that this approach could increase counterparty risk since all borrowing within the industry would be concentrated. We request that the CSA permit the use of foreign lenders, similar to what is set out in Section 6.2(3) of NI 81-102.

A related concern raised by members is that most hedge funds open margin accounts to borrow cash and/or securities with prime brokers (who are typically registered dealers) that may not meet the custodian requirements of Section 6.2 of NI 81-102. We encourage the CSA to engage in further analysis of whether the alternative fund rules can be broadened in this respect to allow for the use of prime brokers by alternative funds.

Prime brokers offer a customized bundle of services to funds, as well as a centralized master account, in addition to lending cash and securities to the funds. The agreements between funds and prime brokers grant the prime broker a security interest over the assets held in such accounts and permit the prime broker to use those assets in the ordinary course of their business. PMAC believes that the borrowing rules should be amended to permit the participation of prime brokers and that they should be expanded to include non-Canadian banks and their affiliated dealers (subject to meeting certain appropriate criteria set by the CSA) in order to allow alternative funds to continue to make use of prime brokers – both Canadian and non-Canadian - and non-Canadian banks and dealers in furtherance of their current strategies.

Currently, many private pooled funds hold their portfolio assets through prime brokers. Subject to appropriate safeguards implemented by the CSA, permitting the use of prime brokers in the alternative fund space may be beneficial in order to allow funds to continue to use their prime brokers for their custody arrangements and for borrowing purposes.

The CSA may also wish to further examine whether to exempt alternative funds from the 10% specified derivatives limit on assets held as collateral in a prime broker account and, in lieu of that limit, for larger funds with a certain amount of assets under management, require the participation of at least two prime brokers. Including prime brokers in the custodial requirements in NI 81-102 for alternative funds could be an effective way of promoting the use of hedge funds. Requiring two prime brokers for these larger funds could assist in limiting counterparty risk. It is often impractical and inefficient for funds to be required to maintain a custodial account alongside a number of

lending relationships and a number of derivatives counterparties. Since the financial crisis, most funds have engaged multiple prime brokers to mitigate counterparty risk and it may be preferable to require funds to have two (or more) prime broker accounts and to focus on the quality and capitalization of the prime brokers as a more effective way to mitigate risk than to impose a counterparty limit on assets held as collateral.

Members also raised concerns with the 50% limit on borrowing, as they believe that restricting borrowing in this way may push funds towards the use of derivatives that may introduce more risk in order to achieve the fund's strategies.

There was also debate among members about the merits of capping the ability of alternative funds to short sell at 50%, with some members taking the view that the 50% cap is appropriate for investor protection and others raising concerns that capping the ability to short sell could - similar to the concerns on the cap on borrowing - push alternative funds to use derivatives to achieve their strategies which may serve to heighten risk. PMAC suggests further consultation may be required on the impact of the 50% limit on short selling.

Members further commented that government bonds should be exempt from the 10% issuer concentration limit on the short selling restrictions. The short sale of government securities is used primarily as an interest rate hedge as they can be more efficient, cost effective and carry a lower risk than hedging the interest rate risk with derivatives. We believe that Section 2.6.1 of the Proposed Amendments should exclude government securities from the short sale single issuer concentration limit. We believe this would be consistent with the exemption of government securities from the long issuer concentration limit in Section 2.1(2)(a) of the Proposed Amendments.

PMAC further suggests that the calculation of borrowed amounts be net of cash and cash equivalents held in the same account. This situation may arise where an alternative fund invests in securities denominated in a foreign currency and the fund's mandate requires the fund to hedge any foreign currency risk.

Certain members have noted it is common for alternative funds and non-redeemable funds to provide a security interest over their portfolio assets in order to secure loans. To that end, these members have suggested that Section 2.6(2)(c) of the Proposed Amendments be modified in order to allow a security interest to be granted over such funds' portfolio assets, provided that it is done in accordance with normal industry practices and on standard commercial terms for the type of transaction.

Total Leverage Limit

There was extensive discussion around the CSA's inquiry regarding which types of strategies currently employed by commodity pools and closed-end funds will be impacted by the proposed 3 times leverage limit. The complexity and divergence of opinions PMAC heard around the advisable quantum of the leverage limit for certain types of funds and strategies suggests that this is an area that warrants further exploration and consultation by the CSA.

Generally, members noted that the "notional amount" used to calculate total leverage does not have a defined meaning beyond "generally recognized standards" to determine such amount – as specifically set out in Section 3.6.3 of NI 81-102. PMAC welcomes further clarification from the CSA as to their expectation regarding the "notional amount", including examples of generally recognized standards in the Companion Policy to NI 81-102 – perhaps including the use of margin to equity - to resolve some ambiguity around this concept.

PMAC also believes that managers ought to be permitted to classify certain derivatives (such as foreign exchange forwards, interest rate swaps and government bond futures) and certain short sales (such as government bonds) used for hedging purposes as excluded from the total leverage

calculation. This is because these types of derivatives and short sales are designed to reduce risk and to limit a fund's ability to use them may encourage funds to turn to riskier derivatives. Short sales that are classified as hedges should also be excluded from the 50% limit on short selling for the same reason.

The CSA has indicated that it is soliciting feedback on alternative leverage measurement methods that may better reflect the amount of, and potential risk to a fund from, leverage than the currently proposed method.

Members presented various alternative methods of calculating leverage for consideration by the CSA. Though no one methodology was endorsed by all members, and, while certain members are supportive of the methodology set out in the Proposed Amendments, the debate demonstrated that the industry supports the adoption of a straight-forward method of leverage calculation - and perhaps leveraging the work already done in Europe on this point - that accurately reflects a fund's exposure as well as the need for further consultation on the appropriate methodology. Members will be making individual submissions on suggested alternative leverage calculation methodologies reflecting their international experience and fund-specific concerns.

Disclosure

PMAC is supportive of the public disclosure requirements in the Proposed Amendments as the requirement to have a receipted prospectus, publish Fund Facts and make available financial statements with position level transparency provides investors with a more consistent disclosure regime than the offering memoranda through which alternative funds are currently offered to investors. Disclosure will be an important way for the mechanics of these alternative funds to be explained to retail investors.

We also urge the CSA to undertake, in conjunction with the industry, a public education campaign about the features, risks and benefits of investing in these new products as a way to bolster investor protection, literacy and the growth of these important asset classes and strategies for the benefit of Canadians. The oversight of these funds by the CSA through the prospectus filing process should serve as an additional investor protection mechanism.

Similar to what was done upon the introduction of Fund Facts and the recent ETF Facts – and which industry found to be very helpful – we ask the CSA to publish a sample of the new form of required disclosure.

Proficiency

PMAC looks forward to reviewing the specific proficiency requirements for the sale of alternative funds. We believe that these proficiency standards should be designed with investor protection in mind as well as to ensure that a sufficient number of qualified individuals will be available to sell these funds so that they are widely available to retail investors.

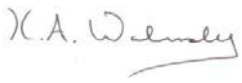
Concluding Comments

The ability for retail investors to have access to alternative asset classes and strategies which are currently only available to high net worth and institutional investors in the exempt market marks a major, but positive, shift for Canadian retail investors. We thank the CSA for the dedication they have demonstrated through the various phases of the Modernization Project. We believe that everyday Canadian investors and our economy can benefit from modern, innovative investment opportunities offered through a well-regulated legal framework. We also appreciate the considerable efforts taken by the CSA to extensively consult with stakeholders, to evaluate the various alternatives that the Modernization Project could have taken and to balance the need for retail investor participation in the alternative fund space with the need for investor protection.

We would be pleased to speak with you further about the remarks in our letter.

Sincerely,

PORTFOLIO MANAGEMENT ASSOCIATION OF CANADA



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December 22, 2016

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Superintendent of Securities, Northwest Territories
Superintendent of Securities, Yukon
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Dear Sirs/Mesdames:

RE : Response to CSA notice and request for comment Modernization of Investment Fund Product Regulation – Alternative Funds

This letter is submitted on behalf of Canadian Imperial Bank of Commerce and its affiliates (collectively, "**CIBC**"), in response to the Request for Comment on the Modernization of Investment Fund Product Regulation – Alternative Funds published

by the Canadian Securities Administrators (the "**CSA**") on September 22, 2016 (the "**Proposed Amendments**").

We would like to thank the CSA for the opportunity to provide our comments on the Proposed Amendments. We support the CSA's initiative to modernize regulation of investment funds with an objective of providing greater diversification of investment strategies, taking into consideration the evolution of alternative strategies in the market place, while remaining focused on investors' protection.

We have reviewed the response letter of the Investment Fund Industry of Canada on the Proposed Amendments and are generally in agreement with their comments.

Below are some general comments on the Proposed Amendments, and comments on specific CSA's questions.

General Comments

Definitions

"Illiquid Assets"

As part of this initiative, we would suggest that the CSA provide clarity on the definition of "illiquid assets". First, we note that NI 81-104 currently provides that "public quotation" used in the definition of the term "illiquid asset" (…), includes any quotation of a price for foreign currency forwards and foreign currency options in the interbank market. We question why a similar interpretation was not included under the definition of "public quotation" in the Proposed Amendments. We also submit that a security should not automatically be deemed to be an illiquid asset only because such security cannot be readily disposed of through market facilities on which public quotations in common use are widely available. We urge the CSA to clarify or make necessary changes to the definition of "illiquid assets" in this context.

"Precious Metal Funds"

We note that a "precious metal fund" is defined under NI 81-104 Commodity Pools as "a mutual fund that has adopted fundamental investment objectives, and received all required regulatory approvals, that permit it to invest in precious metals or in entities that invest in precious metals…". We note that the underlined disclosure has not been included in the definition of "precious metal fund" under the Proposed Amendments. We submit that the investment objectives of existing precious metal funds generally provide that the fund may also invest in companies involved in the precious metal sector or industry. As such, investment in precious metals can be direct or indirect, through investments in companies. We believe that the proposed definition should be revisited on that basis.

Consolidation of prospectuses

With an objective of streamlining the disclosure documents and reducing costs for investors, we urge the CSA to consider allowing fund managers the discretion to consolidate alternative funds and "conventional" mutual funds under the same prospectus. We note that most of the disclosure under the form requirements will apply similarly to both "conventional" mutual funds and alternative funds, with the exception of the labelling and proposed new disclosure for alternative funds. We believe that the distinctions between these funds can be dealt with in the form requirements with clear and concise disclosure. For example, under a consolidated prospectus, the labelling for alternative Funds could still appear on the cover page but could be presented as a separate heading - Alternative Funds – under which all alternative funds would be listed. We further submit that investors will receive the Fund Facts document for an alternative fund in lieu of the prospectus. The Fund Fact document will contain key information about the alternative fund which should be sufficient for an investor to make an informed decision. In our view, the information that will appear in a prospectus with respect to alternative funds would be no different whether it is under a separate prospectus or in a consolidated prospectus with other "conventional" mutual funds.

Collateral

As portfolio assets are pledged as collateral to support borrowing, shorting and specified derivatives transactions, we submit that the use of collateral (re-hypothecation) by borrowing agents or prime brokers is important to reduce costs for alternative funds. Curtailing the use of collateral could put alternative funds at a competitive disadvantage in comparison to their unregulated peers, because the ability to re-hypothecate subsidizes the costs and fees charged to alternative funds by the borrowing agent/ prime broker resulting in lower fees for the funds. Borrowing agents/ prime brokers that are IIROC members are governed by rules that require segregation of those client assets that are fully paid for, but are permitted to re-hypothecate unsegregated client assets that are pledged as collateral for margin loans and other credit consuming transactions. Allowing a similar measured approach as in the IIROC regulations would allow for an even playing field for alternative funds.

Specific Question relating to the Proposed Amendments

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 do not take issue with the proposal to replace “commodity pool” with the use of “alternative fund”.

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.

In our view, the following asset classes common under the typical “alternative” investment strategies should be contemplated: non-guaranteed mortgages, private equity, private debt, and real estate.

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 support the proposal to raise the concentration limit for alternative funds to 20% of the NAV at the time of purchase. This recognizes that alternative funds may be more concentrated in a single issuer as part of their investment strategies. We do not however recommend introducing an absolute upper limit or “hard cap” as we do not think it is necessary to do so. In fact, we believe that introducing a “hard cap” could be harmful to a fund as it could hinder the orderly unwind of a position.

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.

We believe that strategies commonly used by alternative funds, such as real estate and certain arbitrage strategies, would require a higher illiquid asset investment threshold. We encourage the CSA to consider adopting a higher limit in illiquid assets at time of purchase for alternative funds.

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, the CSA should consider how frequently an alternative fund accepts redemptions in considering an appropriate illiquid asset limit. The illiquid asset limit could vary based on the redemption cycle (i.e. monthly, quarterly or annual redemption cycle).

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).

Please refer to our comments under question 5. In our view, the maximum amount of illiquid assets for non-redeemable investment funds should be higher than the proposed cap at 20% of NAV at the time of purchase.

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 believe that alternative funds and non-redeemable investment funds should also have the ability to borrow from foreign lenders and have a broader access to other Canadian lenders. We note that permitting alternative funds and non-redeemable funds to borrow only from entities that meet the definition of custodian would restrict borrowing to a limited number of Canadian prime brokers (i.e. those affiliated with a bank or trust company that is qualified to act as custodian). We think it would be beneficial for these funds to have access to other prime brokers that may not meet the custodian definition as well as to foreign lenders (subject to meeting criteria set by the CSA). Reducing the choice of lenders to only Canadian lenders that meet the definition of custodian in Canada could potentially result in higher costs to the funds and to their investors.

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?

We submit that the use of leverage for a fund does not imply that it will be riskier than another fund that does not employ leverage. It is our view that the notion of leverage can't be considered as a "one size fits all approach" as factors like volatility of investment strategy types will impact the notion of risk attached to it. We also believe that the proposed 3 times leverage limit would be insufficient for certain alternative strategies, including currency management strategies, commodity strategies, managed futures, and fixed income strategies, as it would not be enough to provide decent returns to investors.

For example, we don't believe that a currency management strategy using five or six times leverage would be more riskier than an emerging equity strategy using a 3 times

leverage limit considering that G10 currencies volatility will tend to be in the 8% range (annualized) whereas emerging equities would be in the 18% range.

We would support a higher overall leverage limit in order to accommodate most of the alternative strategies. The maximum amount of leverage would be disclosed in the prospectus and Fund Facts of the fund as suggested under the Proposed Amendments such that an investor and its advisor will have this information available to make an informed decision.

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?

To avoid any confusion in the assessment of the total leverage exposure calculation, we would suggest that the CSA first clarifies the concept of "notional amount".

We believes that certain specific derivatives and certain short sales that are used for hedging purposes should be excluded from the total leverage calculation. Similarly, short sales that are classified as hedges should also be excluded from the 50% limit on short selling.

We note that the IIROC rules deal with a variety of hedged offsets. Although we recognize that there may be monitoring and valuation considerations, we submit that hedged offsets that have generally been accepted under the IIROC rules should be considered by the CSA.

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.

We have concerns with the proposed content for the Fund Facts and the length that the disclosure could take, potentially pushing the Fund Facts to longer than 4 pages.

In our view, the proposed content for the Fund Facts should appear in its appropriate location on the document rather than in a textbox. For example, the disclosure about the asset classes and/or investment strategies and the sources of leverage should be under the "What does the fund invest in?" section. Any necessary risk disclosure should be under the "How risky is it?" section. Leverage information (ratio) could potentially appear under the "Quick facts" section or with the sources of leverage under the "What does the fund invest in?" section.

In our view, the label alternative fund could appear on the first page similarly as what is being proposed for the prospectus. This would avoid additional disclosure such as “this mutual fund is an alternative fund” since this would be obvious from the labelling.

We are also very concerned with the proposition to add disclosure that compares alternative funds with other “conventional” mutual funds. Although this is not our preferred approach, if the CSA considers it is necessary to distinguish these funds from other mutual funds, we would recommend that the definition of alternative funds be used in the Fund Facts rather than a disclosure suggesting a comparison with 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?

Since the Methodology was only released on December 8, 2016 and was not developed for alternative funds, we have not had sufficient time to consider all the impacts the Proposed Amendments could have on its applicability to alternative funds. We believe that the Methodology will notably need to be adapted to take into consideration any leverage limit. We ask the CSA to continue working with the industry to assess the necessary changes to the Methodology for alternative funds.

We appreciate the opportunity to comment on the consultation. If you should have any questions on our comments, please do not hesitate to contact me at 514 876-2073.

Yours truly,

“Geneviève Ouellet”
Senior Counsel
CIBC Legal Department

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December 22, 2016

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

Attention: The Secretary
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Me Anne-Marie Beaudoin
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Montréal (Québec) H4Z 1G3

Dear Sirs/Mesdames:

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

AGF Investments Inc. ("**AGF**") is writing to provide comments in respect of the Canadian Securities Administrators ("**CSA**") Notice and Request for Comment – Modernization of Investment Fund Product Regulation – Alternative Funds (the "**Proposal**").

AGF provides asset management services globally to institutions and individuals. AGF's products include a diversified family of mutual funds, exchange-traded funds, mutual fund wrap programs and pooled funds. AGF also manages assets on behalf of institutional investors including pension plans, foundations and endowments. AGF is registered in the categories of investment fund

manager, mutual fund dealer, exempt market dealer, portfolio manager, and commodity trading manager.

AGF is supportive of the CSA's expansion in the Proposal regarding conventional mutual funds' investments in physical commodities other than gold and certain underlying funds. AGF also recognizes the benefits of allowing alternative funds to be available to retail investors and is appreciative of the opportunity to provide feedback to the CSA on the Proposal.

AGF is generally supportive of the positions being advocated by the industry, including The Investment Funds Industry of Canada (IFIC) and the Portfolio Management Association of Canada (PMAC), with respect to the Proposal.

Naming of new investment funds

AGF submits that the term "non-conventional mutual fund" is not appropriate to describe the investment funds that will be subject to the Proposal as it presupposes that investors understand and appreciate what are/are not "conventional" investment strategies for mutual funds.

Clarification re: leverage and borrowing restrictions

AGF understands that the intention of the CSA is for the proposed leverage and borrowing restrictions in the Proposal to only apply to non-redeemable investment funds and alternative funds, not conventional mutual funds. AGF is requesting that the CSA clarify the proposed drafting changes to section 2.9.1 (for leverage restrictions) and section 2.6.2 (for borrowing restrictions) to reflect the CSA's intention to exclude conventional mutual funds from these investment restrictions.

Investment restrictions – leverage

AGF shares similar views as the industry in submitting that: (i) specified derivatives for hedging purposes should be excluded from the method for calculating total leverage, and (ii) sovereign debt and similar guaranteed debt-like securities should be excluded from the method for calculating limits on short-selling.

AGF also submits that the calculation for maximum leverage under section 2.9.1 in the Proposal does not contemplate the ability to net any pledged collateral or margin associated with the transaction giving rise to the leverage. In practical terms, in the event of any failure to complete or cover a transaction, the pledged collateral or margin would be taken by the counterparty to cover the loss or amounts owing by the investment fund, such that the investment fund is exposed only to the *net* difference. In considering only the notional exposure, the economic reality of the exposure is not being considered in evaluating the investment fund's actual exposure, which may be significantly lower than the calculation yields. This has the effect of restricting certain investment strategies that, because of the existing of pledged collateral, are more conservative than an uncovered strategy. AGF submits that this may be an unintended consequence of the currently proposed calculation.

Further, AGF submits that there are more practical and meaningful ways of controlling risk beyond imposing an absolute limit on leverage based on notional exposure, particularly in the case of

alternative funds and non-redeemable investment funds. In the global markets, we note that there currently exists regulatory frameworks for investment funds (i.e. European UCITS regime) that take a more holistic approach to measuring and monitoring risks. Such frameworks consider standardized risk metrics such as VAR, liquidity scores, margin ratios, volatility ratios, etc. and in their frameworks for leverage and borrowing, contemplate legal rights of offset such as segregated assets, pledged collateral and other similar standard market practices. In looking at the portfolio holistically, the interplay between a number of factors that impact the portfolio are considered and the regulatory framework can accommodate risk tolerance levels by fund type, similar to the approach being taken in respect of short selling, and require disclosures allowing investors the flexibility to select across investment options by risk appetite, in addition to investment strategy and fund type. Such a framework aligns with current know-your-client and suitability obligations of a registrant and allows non-accredited investors to have increased investment options that currently are primarily reserved for accredited investors.

Investment restrictions – fund-of-fund investing

AGF is supportive of the CSA's expansion in the Proposal regarding fund-of-fund structures. The Proposal currently permits conventional mutual funds to invest up to 10% of its net asset value in alternative funds and non-redeemable investment funds. AGF is requesting that the CSA consider increasing this investment level since such underlying funds will be subject to National Instrument 81-102 *Investment Funds*.

Proficiency standards for dealers and advisors

While there are no specific recommendations set out in the Proposal, AGF supports the CSA's intention to engage the Mutual Fund Dealers Association (MFDA) in assessing whether advisors and dealers should be subject to increased proficiency and suitability requirements when distributing alternative funds. In making such determinations, AGF requests that any increased proficiency and suitability requirements not cause increased confusion or burden on an investor; for example, an investor may now have to deal with multiple advising representatives from the same dealer firm with respect to the different investment funds being held in the investor's account with such dealer firm.

We thank you for the opportunity to comment on the Proposal, and look forward to continued constructive dialogue with respect to the Proposal.

Yours very truly,

Mark Adams
Senior Vice President, General Counsel & Corporate Secretary
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To: The Secretary
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Email: comments@osc.gov.on.ca

London, 06 January 2017

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

Dear Sir or Madam,

The Hedge Fund Standards Board (HFSB) welcomes the Canadian Securities Administrators' (CSA) efforts to develop a more comprehensive framework for publicly offered alternative funds. The HFSB regularly provides input on various international regulatory consultations to develop and modernise regulatory frameworks for alternative investments, bringing our unique combination of manager and investor perspectives to the table.

One area of particular interest is the CSA's approach to leverage in investment funds. We note that the CSA proposes a single gross leverage limit of 3 times the fund's NAV.[1] We note that the topic of leverage has been widely consulted on in a number of regulatory consultations in recent years, including the EU Alternative Investment Fund Manager Directive (AIFMD)[2], the Financial Stability Board (FSB) consultations on Proposed Policy Recommendations to Address Structural Vulnerabilities from Asset Management Activities (2016), Oversight of NBNI G-SIFIS (2014)[3] and Strengthening Oversight on Shadow Banking (2012)[4].[5] We have participated in each of these consultations.

In its recent response to the FSB consultation on vulnerabilities in asset management, the HFSB included an analysis of different leverage measures; this highlights some of the shortcomings of gross leverage as a measure or risk. Specifically, we would like to draw the CSA's attention to section

[1] CSA consultation paper: https://www.lautorite.qc.ca/files/pdf/reglementation/valeurs-mobilieres/81-102/2016-09-22/81-102-avis-ACVM-en.pdf p.9
[2] Links to the AIFMD and the HFSB consultation responses to the various AIFMD consultations are available here: http://www.hfsb.org/regulatory-engagement/aifmd/
[3] NBNI G-SIFIS: Non-bank non-insurer Globally Systemic Financial Institutions. Particular focus on gross notional exposure (GNE) to identify NBNI G-SIFIS; the HFSB response highlighted the limitations of GNE
[4] The consultation paper explores "leverage limits" (Question 4); the HFSB consultation response addresses this on page 13 (http://www.hfsb.org/wp-content/uploads/2016/04/hfsb_response_to_fsb_consultation_14_01_2013final.pdf)
[5] Links to all FSB consultations and HFSB responses are available here: http://www.hfsb.org/regulatory-engagement/financial-stability/

3 (p.10ff) of the HFSB consultation response (overview of characteristics of different leverage measures). Some of the key observations in relation to the gross method are set out below:

- The gross method does not account for hedges *(i.e., a hedging transaction (reducing portfolio risk) can increase gross leverage but reduces overall risk)*
- It does not account for the riskiness of the underlying assets *(a low risk portfolio consisting of government bonds with high leverage might still be less risky than an emerging markets equities portfolio with low leverage; notional amounts do not reflect the maturity/underlying of derivative contracts)*
- Gross leverage is not suitable for (risk) comparison purposes between different investment strategies *(many investors employ different approaches to calculate leverage for different investment strategies (Equities, Fixed Income, Currencies, Convertible Bonds…) to obtain a more accurate perspective on risk (usually in combination with other risk measures))*
- The AIFMD does not set out an absolute leverage limit, and the AIFMD commitment method seeks to address a number of the short-comings of gross leverage measures, e.g. by accounting for netting of certain exposures (see p.12ff in the HFSB consultation response for a more detailed analysis of different methodologies)
- The UK FCA highlighted in its 2015 hedge fund survey[6] (which focusses on identifying systemic risk) that gross notional exposure (GNE) (which is used to calculate gross leverage) "does not directly represent an amount of money (or value) that is at risk of being lost" but, instead, represents the gross size of positions taken in the market. The Survey also acknowledged "that hedge funds use risk management techniques to net out directional exposures". Therefore, the UK FCA also refers to the "market footprint" in the context of GNE.
- It also is worth noting that a "hard-wired" leverage limit in certain scenarios can increase distress: in situations where market prices fall, a regulatory leverage limit can exacerbate market price movements, by forcing investors to sell/unwind positions (in order not to exceed the regulatory leverage limit), when in fact the investor might be prepared to hold on to the asset. A leverage limit can also restrict a manager's ability to manage risk in such situations (through hedging etc.).

We hope that this summary assessment is helpful to enhance the understanding of leverage, highlight some of the limitations of gross leverage measures, and further the CSA's efforts to developing a meaningful framework for alternative investments in Canada.

Sincerely,

Thomas Deinet

Executive Director

[6] FCA Hedge Fund Survey, 2015, p. 19: Definition of gross notional exposure and gross leverage https://www.fca.org.uk/publication/data/hedge-fund-survey.pdf

INCLUDES COMMENT LETTERS

FAIR

Canadian Foundation *for* Advancement *of* Investor Rights
Fondation canadienne *pour* l'avancement *des* droits *des* investisseurs

January 9, 2016

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RE: Request for Comment

FAIR Canada is pleased to offer comments on the CSA's Notice and Request for Comment on the Modernization of Investment Fund Product Regulation – Alternative Funds ("the Alternative Funds Proposal").

FAIR Canada is a national charitable organization dedicated to putting investors first. As a voice for Canadian investors, FAIR Canada is committed to advocating for stronger investor protections in securities regulation. Visit www.faircanada.ca for more information.

1. Introduction – Need for More Information on the Alternative Funds Market in Canada

1.1. FAIR Canada is of the view that while there may be some demand for alternative funds by retail investors, this initiative is largely driven by the industry's desire to generate more fees. These funds will be mostly sold by financial advisors rather than bought by retail investors. Accordingly, we are opposed to the new framework which would give retail investors "access" to these funds until a statutory best interest standard is implemented and advisor proficiency is increased.

1.2. In addition, the Alternative Fund Proposal does not provide any evidence which demonstrates that retail investors would be better off from having "access to alternative funds. FAIR Canada therefore believes that before altering the regulatory framework for the sale of alternative funds in order to allow retail investors to have "access" to such funds, the regulators should examine and publish findings regarding the size of the alternative funds market today, the category of

investors who hold such funds and the investor experience, including investor returns (after fees) in Canada (and elsewhere).

1.3. FAIR Canada notes that alternative funds historically have used strategies that limit their liquidity and involve complex strategies. In contrast to traditional mutual funds, which are more diversified and take long-only positions in publicly traded securities, with daily liquidity, alternative funds have been considered too risky for retail investors[1] Alternative funds have been utilized by large institutional investors who do not need immediate liquidity, such as Ontario Teachers Pension Plan, and have been available to accredited investors who are supposed to have the financial ability to obtain expert advice prior to making their investment decision as well as the ability to withstand loss.

1.4. In light of the volatility of equity markets since the 2008 financial crisis, alternative funds are supposed to be able to diversify risk in an investment portfolio by gaining exposure to non-traditional asset classes and hedging strategies that are uncorrelated to equity market returns. At the same time, however, many alternative funds have only been in existence since 2008 and therefore have a limited history in which to gauge how they will perform under market stress.[2] FAIR Canada is not aware of any Canadian data that demonstrates that such funds will help investor returns in volatile markets or otherwise. There is no evidence provided in the Consultation Document that demonstrates alternative funds will benefit retail investors. [3]

Retail Investor Concerns

1.5. Similarly, before adopting changes that will allow conventional mutual funds to invest up to 10% of their net assets in securities of alternative funds and non-redeemable investment funds, the Alternative Funds Proposal should provide stakeholders with the information that demonstrates this will be advantageous to investors who hold investments in these funds. Will the increased costs and decreased liquidity associated with such a strategy be in the interests of the mutual fund's investors?

1.6. FAIR Canada notes that most retail investors will have great difficulty understanding complex products including the strategies that underlie alternative funds. Most retail investors will not properly understand the risk and reward profile of such funds and will rely on their financial services provider when making an investment decision. As described by FINRA in its 2013 alert, "Alternative Funds are Not Your Typical Mutual Funds"[4] and "use investment strategies that differ from the buy-and-hold strategy typical in the mutual fund industry." Most investors will have difficulty understanding their different characteristics and risks.

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[1] See Osler Hoskin and Harcourt LLP's release, Oct. 4, 2016, "Canadian Securities Administrators propose a regulatory framework for offering hedge funds to the public", at p.1-2.

[2] Regulatory brief of Price Waterhouse Coopers, "SEC sweep: Liquid alternative funds", June 2014, at page 3.

[3] In Europe, the European Securities and Markets Authority issued an Economic Report, "Retailisation in the EU, Duly 3, 2013, ESMA/2013/326, that found that from the period 2006 to 2012, the risk-adjusted returns were higher for mutual funds than alternative UCITS, while since mid-2009, the conditional Value-at-Risk has been lower for alternative UCITS, suggesting that investors in those funds are less exposed to losses when markets are bearish.

[4] FINRA, June 13, 2013, "Alternative Funds Are Not Your Typical Mutual Funds", available online at: http://www.finra.org/investors/alerts/alternative-funds-are-not-your-typical-mutual-funds.

Need for a Statutory Best Interest Standard

1.7. In light of the significant problems with the existing relationship between dealers, advisers and their individual registrants with their clients that have been highlighted by FAIR Canada and more recently acknowledged by the CSA in Consultation Document 33-404, FAIR Canada calls on securities regulators to not increase the ability of dealers, advisers and their individual registrants to sell complex products to their clients until a statutory best interest standard is implemented. A retail investor should not be sold an alternative fund unless the dealer and the individual registrant do so on the basis that it is in the best interest of the investor.[5] The present securities regulatory framework does not provide adequate investor protection for mainstream products such as mutual funds, let alone complex products such as alternative funds.

Proficiency Requirements Need to be Raised

1.8. FAIR Canada has also commented repeatedly on the need for increased proficiency for those who profess to advise or otherwise make recommendations to retail investors.[6]

1.9. FAIR Canada agrees that specific training will be necessary for MFDA registrants in order for them to understand the structure, features and risks of any alternative fund securities that he or she may recommend for those in the MFDA channel, in order to meet their KYP obligations. This will also be needed for those who are in a supervisory role. FAIR Canada also believes that IIROC registrants will be in need of such additional training.

1.10. Despite warnings by FAIR Canada and other investor advocates on the dangers of inverse and leveraged ETFs and guidance issued by IIROC and by FINRA, these ETFs continue to be sold to retail investors for whom they are not suitable as noted by OBSI's annual report.[7] Alternative investment funds will likely also be mis-sold unless fundamental changes are made to the regulatory framework including increasing the proficiency of those able to sell these products to retail investors and the incentives that motivate them to do so.

1.11. FAIR Canada calls on securities regulators to not permit the sale of alternative funds to retail investors until the increased proficiency requirements are determined and have been successfully completed by financial services personnel. FAIR Canada believes that heightened proficiency requirements are needed by both IIROC and MFDA individual registrants. In addition, FAIR Canada agrees with the Alternative Funds Proposal that specific training on alternative

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[5] Please see FAIR Canada's comment letter on 33-404 for the necessary aspects of a statutory best interest standard, available online at: https://faircanada.ca/submissions/fair-canada-comments-on-proposed-best-interest-standard-and-proposed-targeted-reforms/.

[6] See FAIR Canada's comments on the Proposed Best Interest Standard (September 30, 2016), available online at: https://faircanada.ca/submissions/fair-canada-comments-on-proposed-best-interest-standard-and-proposed-targeted-reforms/; FAIR Canada's comments on OSC Notice 11-774 Statement of Priorities (May 10, 2016), available online at: https://faircanada.ca/submissions/fair-canada-comments-on-oscs-notice-11-774-statement-of-priorities-2017/; FAIR Canada's Comments on the Preliminary Recommendations of the Expert Committee (July 17, 2016) available online at: https://faircanada.ca/submissions/fair-canada-comments-on-the-preliminary-policy-recommendations-of-the-expert-committee/; and FAIR Canada's comments on IIROC's Proficiency Assurance Consultation (November 17, 2014), available online at: https://faircanada.ca/submissions/iiroc-proficiency-assurance-consultation/ ;

[7] See OBSI's 2015 Annual Report, available online at: https://www.obsi.ca/en/download/fm/500/filename/Annual-Report-2015-1459375786-099e4.pdf

funds is needed.

1.12. FAIR Canada urges securities regulators to not permit the sale of alternative funds with embedded trailing commissions or other incentives that misalign the interests of the dealer and the financial advisor with their clients. The financial industry should not have greater financial incentives to sell these complex products over lower cost, more suitable investment products for retail investors.

Product Governance Requirements

1.13. Improving disclosure and oversight of the sales process has traditionally been the focus of securities regulators. However, other leading jurisdictions have moved beyond this approach and are intervening at an earlier stage to ensure that new products serve the needs of the customers to whom they are marketed. FAIR Canada also calls on securities regulators to consider implementing new product governance requirements before adopting the Proposed Amendments. This should be done in order to ensure that investors are adequately protected throughout the entire life cycle of products and services as well as to ensure that manufacturers and distributors of products act in the clients' best interests. FAIR Canada calls on securities regulators, when considering the Proposed Targeted Reforms in Consultation Document 33-404 and any revisions that may be made, that it consider the approach taken by Europe[8] and the UK.

1.14. It would be helpful if the Consultation Document compared the proposed rules regarding borrowing, short selling, leverage and counterparty requirements to other leading jurisdictions such as the US and Europe. Our understanding is that the SEC recently considered limits on leverage in association with its approach to the use of derivatives by mutual funds and also focused on appropriate risk disclosure for alternative funds. In addition, Europe has specific regulations regarding alternative fund managers which would have been beneficial to set out in the consultation document. How does the approach taken by the CSA compare to that taken in the US or in Europe?

Seed Capital and Organizational Costs

1.15. FAIR Canada questions how the proposed seed capital requirements, including the amount that the investment fund manager is to invest in the alternative fund (currently $50,000 and to be changed to $150,000 with the ability of the manager to remove his investment once $500,000 has been raised from outside investors) compare to other jurisdictions. We are of the view that the investment fund manager should be required to maintain a minimum of $150,000 investment in the fund at all times with no ability to remove this so that they have some skin in the game.

Point of Sale Disclosure

1.16. FAIR Canada continues to believe that better labelling in the name of the fund of the heightened

[8] European Securities and Markets Authority Consultation on Product Governance Guidelines to Safeguard Investors, available online at: https://www.esma.europa.eu/press-news/esma-news/esma-consults-product-governance-guidelines-safeguard-investors

risk and complexity and non-traditional nature of this type of investment fund is needed in addition to the recommendations above. The name "alternative" is meaningless to the average retail investor and does not alert the investor to the complexity and other risks associated with these funds. Focus group testing of possible nomenclature should be conducted.

1.17. FAIR Canada agrees that the CSA should move ahead with point of sale disclosure for alternative funds which will require a fund facts document. Unfortunately, FAIR Canada is very disappointed with the CSA's final rule on how risk will be described in the fund facts document. While we are pleased that a standardized methodology will be used, we are disappointed that the CSA did not require that the Fund Facts document supplement the numerical scale of risk (that classifies its volatility) with a narrative description of the limitations and explain the other risks not covered by the numerical scale (such as counterparty risk). The CSA in its Notice of Amendments to National Instrument 81-102 Investment Funds and Related consequential Amendments dated December 8, 2016[9] finalizing its Mutual Fund Risk Classification Methodology, fails to mention that Europe mandates these supplemental disclosures in addition to the numerical scale. Clearly, when interpreting the IOSCO point of sale disclosure report, Europe decided that that while, in accordance with IOSCO "a scale may be considered appropriate", it also determined that in order for "regulators and investors need to be aware of the inherent limitations in such measures" supplementing the scale with a narrative description of its limitations and the other risks not captured by the synthetic indicator was required.

1.18. FAIR Canada strongly believes that modifications to the CSA Risk Methodology and/or the Fund Facts section on risk is needed in order to adequately inform investors and financial services representatives of the principal risks associated with a given alternative fund. FAIR Canada strongly recommends that the CSA follows the Risk section of the Key Investor Information Document (KIID) used in European countries. 1.23. FAIR Canada believes that the Fund Facts for alternative funds should highlight the risks that these complex products have in light of their liquidity constraints, leveraged positions, derivatives use or otherwise. FAIR Canada believes that supplementing the risk disclosure in Fund Facts is essential to providing investors with the information they need in order to make an informed investment decision.

1.19. The Alternative Funds Proposal suggests changes to Fund Facts to provide additional disclosure by requiring text box disclosure that would highlight how the alternative fund differs from other mutual funds in terms of its investment strategies and the assets it is permitted to invest in. FAIR Canada believes this needs to explain the strategy used in terms that the average retail investor can understand and also describe the principle risks.

Performance Fees

1.20. FAIR Canada recommends that securities regulators provide a standardized definition of high water market and performance fees to prevent the resetting of the high water mark in a manner that harms retail investors.

FAIR Canada believes that the disclosure of performance fees should be tested with retail

[9] (2016), 39 OSCB 9915; available online at http://osc.gov.on.ca/en/SecuritiesLaw_ni_20161208_81-101-81-102_csa-mutual-fund-risk.htm.

investors in order to ensure that the description of these fees is understood.

Marketing and Enforcement

1.21. FAIR Canada also urges the CSA to review the marketing requirements for investment funds and whether these rules need revision and strengthening and/or better enforcement of the existing mutual funds sales practices rules.

We thank you for the opportunity to provide our comments and views in this submission. We welcome its public posting and would be pleased to discuss this letter with you at your convenience. Feel free to contact Marian Passmore at 416-214-3441/marian.passmore@faircanada.ca.

Sincerely,

Canadian Foundation for Advancement of Investor Rights

CC: British Columbia Securities Commission
Alberta Securities Commission
Saskatchewan Financial Services Commission
Manitoba Securities Commission
Ontario Securities Commission
Autorité des marchés financiers
New Brunswick Securities Commission
Registrar of Securities, Prince Edward Island
Nova Scotia Securities Commission
Superintendent of Securities, Newfoundland and Labrador
Superintendent of Securities, Northwest Territories
Superintendent of Securities, Yukon Territory
Superintendent of Securities, Nunavut