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 prices 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.

(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.

[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

(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 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.

[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).

(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 o 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.

The Secretary
Ontario Securities Commission
20 Queen Street West
19th Floor, Box 55
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

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 (if applicable)