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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 - Alternative Funds**

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81-104 – Commodity Pools* (NI 81-104) — which governs commodity funds like gold or precious metal funds — would be repealed as these types of funds would now be governed by NI 81-102.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 10%* of NAV at time of purchase
	No more than 15% of NAV for 90 days or more	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 10% of NAV in one issuer
	No more than 20% of NAV total shorts	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. **Advice 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 just 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.

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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