



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

Me Anne-Marie Beaudoin
Corporate Secretary
Autorité des marchés financiers
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The Secretary
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Toronto, Ontario M5H 3S8
Email: comments@osc.gov.on.ca

Dear Sirs/Mesdames:

Re: CSA Notice and Request for Comment
Modernization of Investment Fund Product Regulation -- Alternative Funds¹

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);

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 leverage⁵ 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

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 pursuing 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 volatility⁶.

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 recommends⁷. 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 Methodology⁸ (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

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.

A handwritten signature in black ink, appearing to read 'Todd Asman', written over a horizontal line.

Todd Asman
Executive Vice-President, Products and Financial Planning