



Canadian Foundation *for*  
Advancement *of* Investor Rights  
Fondation canadienne *pour* l'avancement  
*des* droits *des* investisseurs

January 9, 2017

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**RE: Request for Comment**

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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](http://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<sup>1</sup>. 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.<sup>2</sup> 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.<sup>3</sup>

#### *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"<sup>4</sup> 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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<sup>1</sup> 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.

<sup>2</sup> Regulatory brief of Price Waterhouse Coopers, "SEC sweep: Liquid alternative funds", June 2014, at page 3.

<sup>3</sup> In Europe, the European Securities and Markets Authority issued an Economic Report, "Retailisation in the EU, July 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.

<sup>4</sup> 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.<sup>5</sup> 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.<sup>6</sup>
- 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.<sup>7</sup> 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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<sup>5</sup> 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/>.

<sup>6</sup> 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/iroc-proficiency-assurance-consultation/>;

<sup>7</sup> 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<sup>8</sup> 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

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<sup>8</sup> 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<sup>9</sup> 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 principal 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

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<sup>9</sup> (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](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](mailto:marian.passmore@faircanada.ca) 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