Introducing Liquid Alternatives: Game changer for Canadian hedge funds?

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On September 22, 2016, the Canadian Securities Administrators (the CSA) published their long-awaited proposal for a "liquid alternatives" regulatory framework in Canada (the Proposal). The Proposal primarily involves amendments to the rules contained in National Instrument 81-102 *Investment Funds* (NI 81-102) currently applicable to retail mutual funds and non-redeemable investment funds. The new framework would create a new class of investment funds called "alternative funds" that would be able to use investment strategies that conventional mutual funds cannot use.

Currently, alternative strategies are generally only available through privately offered funds using offering memorandums that are tailored to "accredited investors" and other exempt purchasers. The Proposal has the potential to promote a significant change in the industry, as alternative funds would be able to distribute their securities on a continuous basis to retail investors under a simplified prospectus.

The Proposal also eliminates National Instrument 81-104 *Commodity Pools,* currently applicable to publicly offered commodity pools, and subsumes that regime into the new category of "alternative funds" in NI 81-102. These proposed amendments recognize that the commodity pool rules have generally not been used for funds that are classic "commodity pools". Instead, they have been used for funds that employ derivative strategies not currently allowed under NI 81-102. The Proposal also modifies certain investment restrictions for non-redeemable investment funds (closed-end funds) that were considered to be interrelated with the alterative funds framework.

Background

The Proposal is part of the CSA's broader project over the past few years to modernize investment fund product regulation. The Proposal represents the final stage of the CSA's modernization project and the CSA is seeking comments on a number of points by December 16, 2016.

Highlights of the Alternative Funds Proposal

Below are some highlights of the the alternative funds framework under the Proposal:

- **Definition.** An "alternative fund" is defined as "a mutual fund that has adopted fundamental investment objectives that permit it to invest in asset classes or adopt investment strategies that are otherwise prohibited but for prescribed exemptions from Part 2 of NI 81-102."
- **Concentration.** Investments in any one issuer can be no more than 20% of net asset value (NAV) (in comparison to 10% for conventional mutual funds).
- **Physical commodities.** Alternative funds are exempt from any restrictions relating to the investment in physical commodities.
- **Illiquid assets.** Illiquid assets are limited to 10% of NAV after purchase or 15% of NAV at any time. This same rule currently applies to conventional mutual funds. The CSA recognizes that certain types of alternative funds may wish to hold a larger percentage of their portfolio in illiquid assets (and consequently offer less frequent redemptions) and is seeking feedback on whether a higher illiquid asset limit would be appropriate in such circumstances.
- **Borrowing.** Alternative funds can borrow up to an amount equal to 50% of their NAV. They can only borrow from entities that qualify as investment fund custodians under section 6.2 of NI 81-102, which essentially restricts borrowing to banks and trust companies in Canada (or their qualified dealer affiliates).
- **Short selling.** Short selling is viewed by the CSA as another form of borrowing. Alternative funds can short sell securities up to an amount equal to 50% of their NAV (in comparison to 20% for conventional mutual funds and commodity pools). In addition, in order to facilitate long/short strategies, alternative funds will not be required to have cash cover for their short positions.
- **Combined limit on borrowing and short selling.** The aggregate of all borrowing and exposure under short selling is limited to 50% of NAV.
- **Counterparty requirements.** Unlike conventional mutual funds and commodity pools, which are required to deal in derivatives or with counterparties that have a "designated rating", alternative funds are exempt from these requirements enabling them to engage in OTC derivatives transactions with a wider variety of counterparties.
- **Exposure limit for derivative counterparties.** Alternative funds can use specified derivatives to create synthetic leveraged exposure, although they must limit their mark-to-market exposure with any one counterparty to 10% (subject to a general exception for certain cleared derivatives). This is a departure from current commodity pool rules, which do not restrict counterparty exposure.
- **Total leverage.** The total gross exposure achievable by an alternative fund through borrowing, short selling or the use of specified derivatives cannot exceed three times its NAV. In this calculation, specified derivatives positions are valued at their aggregate notional amount. The leverage limit of three times NAV is a departure from the current commodity pool rules, which have no limit on notional exposure.
- **Redemption price.** An alternative fund may choose to determine its redemption price by reference to the NAV on the first or second business day after the receipt of a redemption order. This is in contrast to the rule for conventional mutual funds which mandates the NAV next determined after the receipt of a redemption order.
- **Redemption deferral.** Provided that it is disclosed in the prospectus of the alternative fund, redemptions can be restricted for a period of up to six months after the receipt for the initial prospectus is issued.

- **Performance fees.** 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 subject to a high water mark.
- **Proficiency and distribution.** The Proposal does not impose additional proficiency requirements for dealing representatives that distribute alternative funds and that are members of Investment Industry Regulatory Organization of Canada (IIROC) firms. The CSA is in discussions with the Mutual Fund Dealers Association to determine the appropriate proficiency requirements for dealing representatives of mutual funds dealers to distribute securities of alternative funds.
- **Offering documents.** Alternative funds can be distributed to retail investors under a simplified prospectus just as conventional mutual funds. Alternative funds not listed on a stock exchange would be subject to the same disclosure regime as conventional mutual funds, which includes the preparation of a simplified prospectus, annual information form and Fund Facts document.
- **Fund Facts document.** The CSA is currently finalizing amendments to implement a summary disclosure document similar to the Fund Facts documents that will be applicable to exchange traded funds (ETFs) called ETF Facts. It is expected that the provisions of the ETF Facts will also be applicable to listed alternative funds.
- **Continuous disclosure.** Alternative funds would be subject to the same ongoing disclosure requirements as other prospectus qualified investment funds, which include annual audited and semi-annual unaudited financial statements, management reports of fund performance, annual information forms and timely disclosure of material changes.
- **Seed capital.** Alternative funds would have minimum seed capital requirements of $150,000, the same as all mutual funds. Managers of alternative funds would be able to redeem this seed capital investment once the fund has raised at least $500,000. This is a departure from the current commodity pool rules, which require the manager to maintain a minimum of $50,000 in seed capital for the life of the commodity pool.
- **Fundamental changes.** The current rules that apply to all investment funds regarding fundamental changes (events requiring shareholder approval) would also apply to alternative funds.
- **Transition period.** If approved, the amendments regarding alternative funds would come into force approximately three months after the publication date of the final rule. For existing funds, the amendments would not apply for an additional six months.
- **Fund-on-fund investing.** Mutual funds would be able to invest up to 10% of their net assets in alternative funds and non-redeemable funds that are subject to NI 81-102. This significantly increases the potential demand for alternative funds, as mutual funds in Canada hold approximately $1.3 trillion in assets.

Limits of the Proposal

Although the Proposal significantly increases the range of strategies that can be offered to retail investors, there remain certain strategies that would not be permitted under this new framework. For example, the proposed limit on short selling (50% of NAV) would not allow a typical 100% long/short market neutral strategy. In addition, the total leverage limit of three times NAV may restrict some managed futures strategies.

Comparison to the United States

For many years, mutual fund rules in the United States have been more flexible than those in Canada. For example, mutual funds in the United States have been able to employ leverage of up to 50% of NAV, a difference which has allowed them to implement alternative strategies not currently permitted for Canadian mutual funds.

Future Opportunities

If the Proposal is approved, it would create significant opportunities for hedge fund managers. Managers that are able to adapt the strategies of their existing closed-end funds or privately offered funds to fit within the Proposal will be able to offer their strategies to retail investors through an open-end platform. This will allow alternative asset managers to market and grow their assets under management through a new distribution channel.

If you have any questions about the Proposal or about the ability of your fund's strategy to fit within the restrictions in the Proposal, a member of the McMillan's Investment Funds and Asset Management Group team would be pleased to assist you.

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McMillan's Investment Funds and Asset Management team helps alternative investment clients in key areas such as structuring, tax, corporate, derivatives, sales and marketing, registration and compliance. Our lawyers are front and centre in key alternative investment industry groups giving them a unique perspective on regulatory changes.

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