



# Liquid Alternatives are Here!

## Game changer for Canadian alternative funds

The Canadian Securities Administrators (the CSA) have approved a new regulatory regime for “alternative mutual funds”

The new rules published by the CSA amending NI 81-102 Investment Funds and NI 81-104 Commodity Pools represent a significant change in the mutual fund industry permitting alternative mutual funds to distribute securities on a continuous basis to retail investors using a simplified prospectus and fund facts.

Prior to the new rules, alternative strategies were generally only available to high net worth investors

and institutional investors through privately offered investment funds using offering memorandums.

These new rules are expected to create significant opportunities for alternative fund managers, exchange-traded funds and conventional mutual fund manufacturers. Managers that are able to adapt the strategies of their existing privately offered funds to fit within the new regulatory framework will be able to offer their strategies to retail investors. This will allow alternative asset managers to grow their assets under management using this new distribution channel.

The new framework creates a new class of investment funds called “alternative mutual funds” that can use investment strategies that conventional mutual funds cannot use. For many years, mutual fund rules in the United States and Europe have been more flexible than those in Canada. **We are catching up!**

## Highlights of the New Rules Permitting Alternative Mutual Funds for Retail Investors

Below are some highlights of the new rules:

- **Definition.** An “alternative mutual fund” is defined as a mutual fund, other than a precious metals fund, that has adopted fundamental investment objectives that permit it to invest in physical commodities or specified derivatives, to borrow cash or engage in short selling in a manner not permitted for other mutual funds.
- **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). This does not apply to “government securities.”
- **Physical commodities.** Alternative mutual 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.
- **Borrowing.** Alternative mutual funds can borrow up to an amount equal to 50% of their NAV. They can only borrow from entities that qualify as an investment fund custodian or subcustodian

under sections 6.2 or 6.3 of NI 81-102, which essentially restricts borrowing to Canadian and foreign banks and trust companies (or their qualified dealer affiliates).

- **Short selling.** Alternative mutual funds can short sell securities up to an amount equal to 50% of their NAV (in comparison to 20% for conventional mutual funds). In addition, in order to facilitate long/short strategies, alternative mutual funds will not be required to maintain cash cover for their short positions.
- **Combined limit on borrowing and short selling.** The aggregate of all cash borrowing and exposure under short selling for alternative mutual funds is limited to 50% of NAV.
- **Counterparty requirements.** Unlike conventional mutual funds which are required to deal with counterparties that have a “designated rating” (generally, a rating of “A” or higher for the counterparty’s long-term debt), alternative mutual funds are exempt from this requirement, enabling them to enter into over-the-counter (OTC) derivatives transactions with a wider variety of counterparties (i.e. counterparties that do not have a designated rating).
- **Exposure limit for derivative counterparties.** Alternative mutual 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%, unless such counterparty has a designated rating in which case the limitation will not apply.

- **Total leverage.** The aggregate gross exposure achievable by an alternative mutual fund through borrowing, short selling or the use of specified derivatives (excluding specified derivatives used for hedging purposes) cannot exceed three times its NAV. The total leverage limit includes exposure gained by the alternative mutual fund from investments in underlying alternative mutual funds that employ leverage. The leverage limit of three times NAV is a departure from the current commodity pool rules, which have no limit on notional exposure.
- **Fund-of-fund investing.** Conventional mutual funds will be able to invest up to 10% of their net assets in alternative mutual funds and non-redeemable funds that are subject to NI 81-102. This significantly increases the potential demand for alternative mutual funds, as mutual funds in Canada hold approximately \$1.5 trillion in assets. Alternative funds will be able to invest up to 100% of their NAV in any other mutual funds or non-redeemable investment funds that are subject to NI 81-102.

# Liquid Alternatives

## Game changer for Canadian hedge funds

- **An alternative mutual fund will be required to have a custodian.** The requirements for entities to qualify to act as custodian or subcustodian of an investment fund have been amended to remove the requirement that affiliates of domestic and foreign banks and trust companies to have publicly available financial statements reflecting the required amount of equity.
- **Redemption price.** An alternative mutual 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 simplified prospectus of the alternative mutual 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 mutual funds may charge performance fees based on the total return of the fund itself. However, performance fees are subject to a permanent high water mark.
- **Proficiency and distribution.** The proficiency requirements contained in NI 81-104 will be amended to apply to alternative mutual funds and NI 81-104 will be renamed *Alternative Mutual Funds*. Accordingly, mutual fund dealers will not be permitted to distribute securities of alternative investment funds unless they meet such proficiency requirements.
- **Offering documents.** Alternative mutual funds can be distributed to retail investors under a simplified prospectus in the same manner as conventional mutual funds. Alternative mutual funds are required to prepare a simplified prospectus, annual information form and fund facts document.<sup>1</sup> There are specific disclosure requirements which need to be contained therein.
- **Fund facts document.** The fund facts/ETF facts for alternative mutual funds must include specific text box disclosure which identifies the fund as an alternative mutual fund, how the alternative fund differs from conventional mutual funds, as well as additional disclosure regarding their lenders (if the alternative fund intends to borrow cash) and the use of leverage.
- **Continuous disclosure.** Alternative mutual funds are subject to the same ongoing disclosure requirements as other prospectus qualified investment funds and will be required to disclose actual use of leverage in their financial statements, similar to the current requirements for commodity pools. The requirements in NI 81-104 are being repealed and moving to NI 81-102.
- **Seed capital.** Alternative mutual funds have a minimum seed capital requirement of \$150,000, the same as all mutual funds. Managers of alternative mutual funds will be able to redeem this seed capital investment once the fund has raised at least \$500,000 from investors. 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 unitholder approval) will also apply to alternative mutual funds.
- **Transition period.** The amendments regarding alternative mutual funds will come into force on January 3, 2019. The CSA is providing a transition period until July 4, 2019 to grant existing commodity pools additional time after the Amendments come into force to make any necessary operational changes.

1. Alternative mutual funds listed on an exchange will be required to prepare a long form prospectus and ETF facts.

## Commodity Pools and Non-redeemable Investment Funds

Commodity pools and non-redeemable investment funds previously offered to the public under NI 81-104 will now be classified as alternative mutual funds and NI 81-104 will be renamed “*Alternative Mutual Funds*”. The new rules also modify certain investment restrictions for non-redeemable investment funds (closed-end funds) that were considered to be inter-related with the alternative mutual funds framework.

Alternative mutual funds have been offered to retail investors for years in the U.S. as so-called “40 Act funds” and in Europe under the UCITS banner, and will now be available to Canadian retail investors on the same basis as conventional mutual funds.

McMillan lawyers would be pleased to answer any questions you may have about the new rules.

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## Firm profile

McMillan's Investment Funds and Asset Management Group has lawyers that are front and centre in key industry groups. We advise many Canadian and non-resident fund managers, dealers and portfolio managers on Canada's complex registration and compliance obligations. We provide solutions-oriented legal advice through our offices in Vancouver, Calgary, Toronto, Ottawa, Montréal and Hong Kong. Our firm values respect, teamwork, commitment, client service and professional excellence are at the heart of McMillan's commitment to serve our clients, our local communities and the legal profession. For more information, please visit our website at [www.mcmillan.ca](http://www.mcmillan.ca)