Canadian Securities Regulators Permit Retail Liquid Alt Funds and Ease (Some) Investment Restrictions for All Public Funds

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On January 3, 2019, amendments to National Instrument 81-102 *Investment Funds* (NI 81-102) and its companion policy, as well as related national instruments, will come into force. These amendments will permit "alternative mutual funds" (colloquially referred to as liquid alt funds) to be offered to retail investors in Canada in a similar manner as conventional retail mutual funds. These amendments provide fund managers with new opportunities and challenges in offering retail investors access to alternative strategies. Overall, the amendments are a breath of fresh air in a regulatory environment that has become increasingly restrictive.

The amendments bring publicly offered mutual funds, alternative mutual funds, non-redeemable investment funds (closed-end funds) and exchange-traded funds (ETFs), in their various forms, under the same regulatory regime, and loosen certain investment restrictions and practices that apply to the various forms of investment funds. Also notable is the fact that all public *mutual* funds (including alternative mutual funds, but not ETFs) will be offered under the simplified prospectus, AIF and fund facts regime established by National Instrument 81-101 *Mutual Fund Prospectus Disclosure* (NI 81-101). Closed-end funds and ETFs will continue to use the "long-form" prospectus regime.

Liquid alt funds created under the January 2019 amendments will represent a hybrid between conventional mutual funds and privately offered hedge funds. Until now, liquid alts could only be launched as “commodity pools” under the increasingly outdated (and cumbersome) National Instrument 81-104 *Commodity Pools* (NI 81-104) or pursuant to discretionary exemptions from the requirements of NI 81-102, which have been granted only sparingly within the past year to a handful of applicants. Essentially, the Canadian Securities Administrators (the CSA) have renamed "commodity pools" as "alternative mutual funds" and have updated, to a limited extent, the regime that previously applied to commodity pools under NI 81-104.

NI 81-104 will be largely withdrawn, with its provisions moved to NI 81-102, or the other applicable 81-series national instruments. NI 81-104, however, will remain with the sole purpose of continuing to regulate the proficiency standards for mutual fund dealers and their representatives who wish to recommend alternative mutual funds to their clients.

There has been no change made to those proficiency standards, pending further review of proficiency standards more generally by the CSA.

In addition to making a number of technical tweaks, the CSA made some notable changes from the proposed amendments first published for comment in September 20161:

- The term "alternative mutual fund" (rather than "alternative fund") is used to reinforce the fact that these funds must have a redemption feature consistent with other mutual funds.
- Existing non-redeemable investment funds will be exempted from the new investment restrictions applicable to them provided they remain out of distribution (that is, unless they file a new prospectus to qualify a new offering of securities).
- Government securities are excluded from the 10 per cent single issuer concentration limit on short sales by an alternative mutual fund or a non-redeemable investment fund.
- The 10 per cent of NAV derivative counterparty threshold will not apply for cleared derivatives or for over-the-counter derivatives if the counterparty has a designated rating.
- The aggregate notional amount of specified derivative positions that are hedging transactions will not be required to be included in calculating aggregate leverage of alternative mutual funds for the purposes of the 300 per cent leverage cap.
- The limit on assets that may be deposited with a single borrowing agent (that is not the fund's custodian) as security in connection with a short sale is increased to 25 per cent for alternative mutual funds and non-redeemable investment funds.

Changes in Fund Investment Restrictions

Alternative mutual funds will be subject to somewhat relaxed investment restrictions. The amendments also effect some welcome changes to the investment restrictions applicable to other mutual funds, and some less welcome changes for non-redeemable investment funds. Please access BLG's *Investment Restrictions for Public Investment Funds – At a Glance!* for more information.

Highlights of the new investment restrictions include:

Restrictions on Illiquid Assets – The permitted level of investment by alternative mutual funds in illiquid assets will be the same as for conventional mutual funds – being 10 per cent of NAV at the time of purchase, with a hard cap of 15 per cent of NAV. Non-redeemable investment funds will have a limit of 20 per cent of NAV at the time of purchase, with a hard cap of 25 per cent of NAV. Despite industry lobbying to relax these limits, the CSA have imposed the lower limit on alternative mutual funds, reflecting the CSA's focus on liquidity management for retail funds, which is indicative of the broader international regulatory focus in this area.

Permitted Borrowing – Alternative mutual funds and non-redeemable investment funds will be permitted to borrow up to 50 per cent of the fund's NAV, subject to conditions, including:

- Lenders must be entities that would qualify as a qualified custodian under NI 81-102 (*i.e.*, banks and trust companies in Canada, and certain affiliates).
- The fund's independent review committee (IRC) must approve any borrowing where the lender is an affiliate of the fund's investment fund manager.
- Any borrowing agreements entered into must be in accordance with normal industry practice and must be on standard commercial terms.

Conventional mutual funds will continue to be restricted to a maximum borrowing limit of 5 per cent of their net asset value and for limited purposes only.

Permitted Short-Selling – Alternative mutual funds and non-redeemable investment funds will be permitted to engage in short-sales of securities up to a limit of 50 per cent of NAV, with the maximum amount of securities of a single issuer (measured by aggregate market value) that may be sold short being limited to 10 per cent of NAV. Alternative mutual funds and non-redeemable investment funds will also be exempt from the requirement to hold cash cover, and from the prohibition on the use of short-sale proceeds to purchase securities other than securities that qualify as cash cover. Conventional mutual funds will remain subject to the pre-existing limits on short-sales.

No more than 25 per cent of the assets of an alternative mutual fund or non-redeemable investment fund (as a percentage of NAV) may be deposited as security in connection with short sale transactions with any one borrowing agent that is not the fund's custodian. Conventional mutual funds will remain subject to a 10 per cent limit.

Aggregate Borrowing and Short-Selling Limit – Alternative mutual funds and non-redeemable investment funds will be subject to an overall limit on the use of cash borrowing and short-selling of 50 per cent of NAV.

Use of Derivatives – The amendments codify exemptions previously and routinely granted to investment funds from the counterparty designated rating, the counterparty exposure limits, and the custody provisions, by exempting investment funds from those requirements in connection with "cleared specified derivative" transactions.

Alternative mutual funds and non-redeemable investment funds will be permitted to enter into derivative transactions in which the derivative counterparty and/or guarantor of the counterparty does not have a "designated rating". While all investment funds are subject to the 10 per cent counterparty exposure limit, this limit does not apply in respect of any cleared derivatives or if the equivalent debt of the counterparty or its guarantor has a designated rating.

Alternative mutual funds and non-redeemable investment funds will be exempt from the cover requirements to allow the use of derivatives to create synthetic leveraged exposure, subject to the overall limits on leverage discussed below.

Aggregate Leverage Limit – Alternative mutual funds and non-redeemable investment funds will be permitted to use leverage through cash borrowing, short-selling and specified derivative transactions. However, the aggregate leverage of an alternative mutual fund or a non-redeemable investment fund, calculated as the sum of total amount of outstanding cash borrowed, combined market value of securities sold short, and the aggregate notional amount of all specified derivative positions that are not entered into for hedging purposes, will not be permitted to exceed 300 per cent of the

fund's NAV. Fund managers will be required to monitor each fund's total leverage on a daily basis. Refreshingly the CSA did not adopt the 2016 proposal that would have included derivative transactions entered into for hedging purposes in the leverage calculation.

Rehypothecation – Under the custodial provisions of NI 81-102, an investment fund is permitted to deliver collateral to its futures commission merchant, derivatives counterparty, lender or borrowing agent only if certain conditions are met. In the case of collateral posted for derivatives or cash borrowings, one of the conditions continues to be that the records of the persons holding the assets must show that the investment fund is the beneficial owner of the assets posted by it as collateral. The CSA considers that this condition prevents any rehypothecation of collateral that is subject to these provisions, as the effect of rehypothecation is to alienate beneficial ownership. This condition does not apply to assets posted as security in connection with the short sale of securities, and the regulators have previously indicated that this does not apply in connection with variation margin for derivative positions. Operationally, however, we expect that it may be difficult to distinguish between collateral securing derivatives (initial margin) and cash borrowing obligations versus collateral securing derivatives (variation margin) and short selling obligations.

Investments in Other Investment Funds (Fund-of-Fund Structures) – The amended rules will facilitate fund-of-fund structures by easing restrictions applicable to conventional mutual funds and alternative mutual funds. The more liberal regime for non-redeemable investment funds remains unchanged, except to add alternative mutual funds to the list of permissible investments. Conventional mutual funds will be permitted to invest up to 10 per cent of NAV in securities of alternative mutual funds and non-redeemable investment funds, and up to 100 per cent of NAV in any other mutual fund (which includes ETFs), provided that the underlying fund is subject to NI 81-102 and the "three-tier" restrictions and the other fund-of-fund rules are respected. Investments in "index participation units", which will now only cover U.S. listed index ETFs, remain permitted as is the case today. Alternative mutual funds and non-redeemable investment funds may invest up to 100 per cent of NAV in any other non-redeemable investment fund or mutual fund (including other alternative mutual funds) provided that such underlying funds are subject to NI 81-102 and the other fund-of-fund requirements are met. They may also invest in "index participation units".

All investment funds subject to NI 81-102 will remain prohibited from investing in non-prospectus qualified funds (pooled funds) even when those pooled fund comply with the same investment restrictions, which continue to be a disappointing regulatory position.

Investment in Additional Physical Commodities – The amendments expand the scope of permitted investments in physical commodities for conventional mutual funds to allow investments directly in silver, palladium and platinum in addition to gold (including certificates representing these precious metals) and to allow conventional mutual funds to obtain indirect exposure through specified derivatives. Investments in commodities are still subject to a limit of 10 per cent of a conventional mutual fund's NAV, which includes any investments in these commodities made by an underlying fund. Precious metals funds have more flexibility. Neither alternative mutual funds nor non-redeemable investment funds are subject to any prohibition on investing in commodities.

Other Requirements for Alternative Mutual Funds

Although many of the same requirements that applied to "commodity pools" continue to apply alternative mutual funds under the amendments to NI 81-102, there are some changes. In most cases, the rules that apply today to conventional mutual funds, ETFs and non-redeemable investment funds in these areas have not changed.

- Offering Documents – Alternative mutual funds not listed on an exchange will be subject to the same disclosure regime as conventional mutual funds, being NI 81-101, rather than the "long-form" prospectus regime previously mandated for commodity pools. The simplified prospectus of an alternative mutual fund, as well as the fund facts, will be required to include face page disclosure that identifies the fund as an alternative mutual fund and text box disclosure that describes how the investment strategies and asset classes to be utilized by the alternative mutual fund differ from conventional mutual funds, and any attendant risks associated with such strategies or asset classes. In addition, alternative mutual funds may not be included in with the prospectus documents for any conventional mutual funds.
- Seed Capital Requirements and Responsibility for Organizational Costs – Seed capital requirements for new alternative mutual funds will be the same as for conventional mutual funds – $150,000. In addition, alternative mutual funds will be subject to the same prohibition against reimbursement of organizational costs as conventional mutual funds.
- Initial Lock-up Period – An alternative mutual fund will be permitted to impose an initial six-month lock-up period, during which redemptions will not be permitted, provided that such restriction is disclosed in the prospectus. They will be able to calculate redemption proceeds based on the first or second business day after the date of receipt of a redemption order.
- Incentive Fees – Under NI 81-102, incentive fees must be calculated and charged based on the cumulative total return of the fund. Alternative mutual fund managers that are accustomed to using series accounting to effectively calculate and charge performance fees at the unit level must consider the impact of this requirement.
- Risk Assessments – No changes have been made to the "investment risk classification" contained at Appendix F of NI 81-102 for alternative mutual funds, although the CSA encourages managers to consider "other factors or risk metrics" and determine whether it would be appropriate to make an "upward adjustment" to the fund’s risk level.

Transition

The amendments come into force January 3, 2019. For existing commodity pools that filed a prospectus for which a receipt is issued on or prior to January 2, 2019, there will be a transition period ending July 4, 2019, by which date they must be fully compliant with the new rules.

Non-redeemable investment funds existing as of October 4, 2018 will be exempt from most of the new requirements applicable to them, unless they file a prospectus for which a receipt is issued after that date.

Industry Considerations

Alternative Fund Managers

The alternative fund rules represent an opportunity for the managers of hedge funds and other alternative funds to offer a version of their funds, which were previously only offered to high net worth individuals and institutional investors in the private market, to Canadian retail investors. Some considerations for alternative fund managers looking to "go retail" for the first time include:

- They will be subject to a greater level of regulation and fund governance, including independent review committees, than is required in the exempt market and will need to ensure that they have the infrastructure, including policies and procedures, and personnel required to stay compliant.
- Investment strategies may need to be amended in order to comply with the restrictions contained in NI 81-102, which may impact fund performance. Relief from what is provided for in NI 81-102 may not be available.
- Start-up and organizational costs must be funded by the manager.
- The challenges of distributing retail products, including getting funds onto approved lists at dealers, and the impact of the proficiency requirements on the traditional mutual fund distribution channel.
- The interaction of custodial requirements under NI 81-102 and prime brokerage agreements will present some legal and operational challenges.
- Sales forces will need to be educated on the new product and suitability considerations, as well as the additional proficiency requirements necessary to sell alternative mutual funds.
- The sales communication rules in NI 81-102 will prohibit the linking of the performance of existing private alternative mutual fund strategies with that of an alternative mutual fund offered under a prospectus. Even if the existing private fund is "converted" into a NI 81-102 compliant fund, performance of the fund prior to the date of the final prospectus receipt will be prohibited unless exemptions are granted.

Conventional Mutual Fund Managers

Conventional mutual fund managers will benefit from the codification of various exemptions from NI 81-102 contained in the amendments, including the expanded scope of permitted investment in physical commodities, more flexibility for investments in other funds and relief from the counterparty designated ratings and exposure limits for derivatives cleared through a "specified clearing corporation". This new flexibility can be relied upon immediately on and after January 3, 2019, and fund managers will want to consider how and whether their funds can benefit from the increased investment flexibility.

In addition to some of the considerations listed above for alternative fund managers, additional considerations for conventional mutual fund managers wishing to offer alternative mutual funds include:

- Alternative investment strategies require a different skillset and managers must consider whether they can develop that skillset internally or whether they need to look outside their organization for expertise.
- Compliance software that is geared to the rules for conventional mutual funds will need to be modified.
- Risk management personnel will need to consider additional factors, including the impact of higher leverage.

- Converting an existing fund into an alternative mutual fund will likely necessitate securityholder approval, as a change in investment objectives and strategies for the fund to convert the fund into an alternative mutual fund would no doubt be a change to the fund's fundamental investment objectives, requiring a securityholder vote.

Non-Redeemable Investment Fund Managers

Unless their funds are exempt (*i.e.* they were established before October 4, 2018 and do not file a new prospectus after that date), non-redeemable investment fund managers will need to carefully review their current investment strategies and make modifications to their strategies and related compliance monitoring in order to adopt the new investment restrictions imposed by the amendments.

Investors

The average Canadian retail investor may be the ultimate beneficiary of the amendments, as they will be introduced to new and varied investment options that may help achieve their investment goals. A component of the amendments is the "one-stop shopping" element, which will enable investors to purchase conventional mutual funds and alternative mutual funds under similar offering documents and through familiar distribution channels, which should facilitate comparisons between investment options.

We encourage you to contact your usual lawyer in BLG's Investment Management Group to discuss how the January 2019 amendments may affect how you manage your investment funds. We have considerable experience in working with managers of funds with alternative investment strategies and would be pleased to discuss with you how you can establish a new alternative mutual fund or convert any of your existing funds into alternative mutual funds in compliance with the new regime. For further information, please contact any of the authors of this Bulletin, or any member of BLG's Investment Management practice group.

1 See "Canadian Regulators Unveil Draft Rules to Permit the Offering of Alternative Mutual Funds to Retail Investors," October 2016.

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