2020 Spotlight on alternative mutual funds – opportunities ahead

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Alternative investments are in the 2020 spotlight, with investors looking for investment opportunities to weather the market volatility associated with the global COVID-19 pandemic. Alternative mutual funds (colloquially referred to as “liquid alt funds”) can provide value to investors who want to protect their investment, while also taking advantage of market opportunities. As investors become increasingly open to alternative investment opportunities during the global pandemic, liquid alt funds may emerge as a must-have component of a portfolio’s personal protective equipment.

Liquid alt funds are a form of alternative investment that have received much attention over the past year. Amendments to National Instrument 81-102 *Investment Funds* (NI 81-102) became effective on Jan. 3, 2019, which allowed funds with alternative investment strategies to be distributed to retail investors. Now that alternative mutual funds have operated for a year and a half under NI 81-102, this Bulletin summarizes our views on what has happened in the liquid alt market since 2019, what issues have arisen and how they have been resolved, and which remain outstanding.

What the liquid alt rule changed

Liquid alt funds represent a hybrid between conventional mutual funds and privately offered hedge funds. The 2019 amendments to NI 81-102 created more relaxed investment restrictions for liquid alt funds compared to conventional mutual funds. Specifically, the amendments permit liquid alt funds to use cash borrowing, short selling, and derivative transactions to leverage the fund by up to 300 per cent of the fund’s net asset value (NAV), subject to certain conditions[1].

Market updates since January 2019

A year and a half after the introduction of the new regime, the Canadian Association of Alternative Strategies and Assets (CAASA) reported that the market for liquid alt funds has reached a value of ~ $10 billion in Canada and as of July 2020, there were 106 liquid alt funds launched by almost 40 different managers. Bank-owned and large independent fund companies have been dominating the space, with the Alternative Investment Management Association (AIMA) stating that these managers were

responsible for more than two-thirds of assets under management (AUM) at the start of 2020.

Currently, the liquid alt market is dominated by equity funds focused on generating alpha, rather than funds employing market neutral strategies or fixed income funds using credit strategies. We have also seen a number of multi-strategy funds launched. We expect the lack of market neutral strategies relates partly to the fact that the investment restrictions of NI 81-102 are not sufficiently flexible to permit use of these strategies, absent exemptive relief. Managers of liquid alt funds have typically adopted redemption features, management fees, and low investment minimums that are consistent with conventional mutual funds. A number of funds also pay a performance fee, typically falling between 15-20 per cent. However, some managers have chosen to align with conventional fund fee structures and not charge the funds a performance fee at all.

A number of liquid alt fund launches took the route of converting private hedge funds into NI 81-102 prospectus-qualified funds, while others were new funds. A few liquid alt funds arose from converting funds that were qualified under the commodity pool regime or converting existing conventional mutual funds. One benefit of converting an existing private fund is that – to the extent the fund's strategy is compliant with NI 81-102 – it is possible to get exemptive relief to show past performance. Having a longer track record may make it easier to gain distribution for the fund, as dealers and investors are able to get a better understanding of the overall performance of the product.

Barriers to distribution

Despite the recent popularity of liquid alt funds, there are some systemic issues affecting the new fund category that may limit widespread adoption and distribution of these new products.

Risk ratings

NI 81-102 requires an alternative mutual fund to adopt a risk rating calculated in accordance with prescribed Canadian Securities Administrators (CSA) methodology, which is based on the volatility of the fund. Using this methodology, many liquid alt funds can achieve a lower risk rating because they employ strategies aimed at mitigating volatility. Notwithstanding these lower mandated risk ratings, many distributors choose to assign a higher risk rating to the alternative mutual funds that they put on their shelves. These higher risk ratings from dealers restrict the number of clients for whom the liquid alt funds may be suitable, given the general perception that alternative strategies are riskier. Further, even when liquid alt funds are suitable for a client, the higher risk ratings may limit the willingness of a dealer to allocate a large percentage of a client's portfolio to alternative mutual funds.

Proficiency requirements

When the liquid alt regime came out, the CSA stated that the next phase of amendments would look at updating the proficiency requirements for individual dealing representatives (advisors) that sell these funds. In the meantime, the CSA decided to

keep the existing proficiency requirements from National Instrument 81-104 *Alternative Mutual Funds* for distributing commodity pools.

Currently, in order to offer liquid alt funds to clients, advisors have to complete one of three specified courses:

- The Canadian Securities Course (CSC);
- The Derivatives Fundamentals Course; or
- The Chartered Financial Analyst (CFA) Program.

Many advisors, who are registered with firms that are members of the Mutual Fund Dealers Association of Canada (MFDA), have not completed these courses. Thus, contrary to popular belief, MFDA-registered advisors are not prohibited from distributing liquid alt funds. However, most MFDA advisors and supervisors lack the required proficiency. The current requirements effectively limit the distribution of liquid alt funds to advisors registered with investment dealers that are members of the Investment Industry Regulatory Organization of Canada (IIROC).

There is an ongoing discussion regarding what the new proficiency standards should be to sell liquid alt funds. Although this item has been on the regulatory "to-do" list for a while, we have not seen significant movement by the CSA. This has prompted a number of trade associations to come up with their own recommendations as to what the updated proficiency requirements should be for liquid alt funds, with a goal to achieve a less onerous standard for advisors.

AIMA's recommendations

On Jan. 30, 2020, AIMA released a proposal recommending that MFDA member firms be able to select from acceptable independent course material that is currently available in the market. AIMA specifically highlighted the CAIA Designation, CAIA Fundamentals Certificate Course, and CSI Alternative Strategies: Hedge Funds and Liquid Alternatives Course as recommended options. AIMA also recommended a phased development of proficiency standards to allow MFDA members the opportunity to produce a customized "in-house" course that could also satisfy the standard.

IFIC's recommendations

Similarly, in February 2020, the Investment Funds Institute of Canada (IFIC) recommended changes to the proficiency requirements for MFDA advisors in a letter addressed to the MFDA and the Ontario Securities Commission (OSC). IFIC's recommendation is that the MFDA work with course providers, such as the IFSE Institute (IFSE) and CSI Global Education Inc. (CSI), to introduce a bridging course and exam for existing registrants. This requirement would apply to supervisors as well. The bridging course material would focus on the key elements of alternative mutual funds, and include any content related to the funds that the CSC covers, but is not currently included in the IFSE and CSI investment funds courses. For those seeking to become registrants, IFIC proposes the Canadian Investment Funds Course or the Investment Funds in Canada Course incorporate this bridging material.

The CSA have not publicly discussed the status of their consideration of these recommendations. Given that the existing proficiency requirements are embedded in a CSA rule, action is required by the CSA in order for any changes to move forward.

Exemptive relief

Since 2019, we have seen various exemptions granted by the CSA to remedy concerns raised by the new regime. These include relief from/to:

- The short-selling restrictions to permit a fund to short sell "government securities" up to a maximum of 300 per cent of a fund's NAV;
- The custodial requirements to permit assets representing more than 25 per cent of NAV to be deposited with a borrowing agent that is not the liquid alt fund's custodian or sub-custodian, as security in connection with a short sale;
- Include past performance data of a fund for the period prior to it becoming a reporting issuer in sales communications, fund facts and annual and interim financial management reports of fund performance;
- Allow the fund to purchase securities of an issuer in excess of the 20 per cent of NAV limit for any one issuer;
- Allow the fund to short sell units of specified index funds (known as index participation units) up to 100 per cent of the fund's NAV at the time of sale;
- Allow short sales of up to a maximum of 100 per cent of a fund's NAV in connection with "market neutral" or other short selling strategies;
- Allow aggregate exposure to cash borrowing, short selling and specified derivatives transactions in excess of 300 per cent of the fund's NAV;
- The custodial requirements to permit funds to appoint more than one custodian for securities lending purposes.
- The concentration restriction requirements to invest more than 20 per cent of NAV in debt obligations of, or guaranteed by, either the Federal National Mortgage Association (Fannie Mae) or Federal Home Loan Mortgage Corporation (Freddie Mac).
- Allow the fund to process purchase and redemption orders for units on a monthly or semi-monthly basis; and
- Permit a simplified prospectus for an alternative mutual fund to be consolidated with a simplified prospectus for a conventional mutual fund. Since National Instrument 41-101 *General Prospectus Requirements* does not contain an equivalent requirement, a prospectus for a liquid alt ETF may be consolidated with a prospectus for a conventional ETF without obtaining an exemption.

The CSA have also clarified that, notwithstanding statements previously made, nothing in NI 81-102 precludes a liquid alt fund from permitting the portfolio assets deposited by it to be rehypothecated.

A look into the future of liquid alt funds

The alternative mutual fund market is still relatively new in Canada and has great potential for growth. Current market dynamics will likely contribute to further traction for alternative investments, with liquid alt funds becoming an increasingly attractive option for investors outside of bull market conditions. Changes in the use of risk ratings and

revised proficiency requirements are additional factors that should contribute to further success of the product category in the near future.

There is no doubt that the industry will continue to closely watch and assess how liquid alt funds deliver over the course of this next year. We encourage you to contact BLG's Investment Management Group to discuss how you can offer an alternative mutual fund. We have considerable experience in working with alternative fund managers and would be pleased to discuss how you can establish a new alternative mutual fund or convert your existing funds into alternative mutual funds in compliance with the rules. For further information, please contact the authors of this Bulletin or any member of BLG's Investment Management Group.

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[1] Please see BLG's 2018 bulletin, *Canadian Securities Regulators Permit Retail Liquid Alt Funds and Ease (Some) Investment Restrictions for all Public Funds*, for more details regarding the NI 81-102 amendments and the liquid alt fund investment restrictions.

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