

The AIMA logo consists of the letters "AIMA" in a white, sans-serif font, centered within a dark blue square that has a red horizontal bar at the bottom.

AIMA & Scotiabank Global Banking & Markets presents

Handbook to Launching Alternative Mutual Funds in Canada





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Introduction



By: Daniel Dorenbush,
MBA, CFA

Managing Director,
Head of Canadian Prime Services,
Scotiabank, Global Banking
and Markets



The Canadian Securities Administrator (CSA) has completed the new rules that will modernize the regulation of investment funds in Canada. On October 4, 2018, the CSA published the final iteration of amendments to National Instrument 81-102 (subject to a 90-day adoption period). These new rules include, amongst other changes, an Alternative Mutual Fund category.

Once formally adopted, these rules will permit alternative mutual funds to be sold to investors in Canada in much the same manner as conventional mutual funds.

Alternative Mutual Funds will be able to employ strategies that were previously utilized primarily by hedge fund managers such as shorting and the use of leverage – within strictly regulated limits.

These changes present the potential opportunity for retail investors in Canada to access a product that was previously only available to a limited segment of the investment community. The changes are also likely to produce new opportunities for hedge fund managers and mutual fund manufacturers who will be able to create and more broadly distribute funds that employ Alternative strategies.

Along with these new opportunities will come challenges to various industry stakeholders. The purpose of this handbook is to address some of these issues and highlight areas that Alternative Mutual Fund managers should focus on when developing, launching and distributing a new Alternative Mutual Fund.

Scotiabank, in conjunction with AIMA, has canvassed a number of industry leaders and subject matter experts to produce this handbook for managers and service providers to reference as the industry prepares to adopt this new product.

The following items will be addressed in this publication:

- **Legal issues and launch considerations**
McMillan
- **Prime Brokerage Services**
Scotiabank
- **Fund Distribution**
Mackenzie Investments
- **Custody**
CIBC Mellon
- **Strategies for Alternative Managers**
Edgehill Partners
- **Fund Administration**
SGGG
- **Audit & Accounting**
KPMG

We would like to thank the individuals and firms that have contributed to this project and we look forward to the continued sharing of insights and expertise.

Thank you,

Daniel Dorenbush



By: **Belle Kaura**
BCL, LLB, LLM, VP Legal,
Chief Compliance Officer
Third Eye Capital
Chair, AIMA Canada Executive
Committee, 2018-2020



Alternative Mutual Funds Framework comes to Canada

The Canadian alternative investment management industry is excited that the much-anticipated alternative mutual funds framework is finally here. This innovation is the largest that industry in Canada has seen in years and promises to see a convergence between traditional fund manufacturers and boutique hedge fund managers as an increased adoption of hedge fund strategies is expected by retail advisors to serve retail investors.

These rules represent the successful culmination of many years of regulatory advocacy by AIMA Canada volunteers on behalf of our members and our industry. We are pleased to have played an active role in shaping the alternative mutual funds framework since inception of the proposal in 2013 through to the final rule.

The new alternative mutual funds framework will be transformational for the alternative asset management industry in Canada and for the retail investing public. There is wide consensus that these funds have the potential to have a meaningful market impact, with early forecasts that the Canadian retail market could reach \$100 billion over the next five years. Retail demand for alternative products is expected to drive widespread distribution allowing Canadian advisers greater access to products that can add value for their clients. Canadian alternative investment managers will now be on the same playing field as managers in the US and UK with the ability to offer their products to retail investors in Canada for the first time.

Historically, alternative investment products providing exposure to alternative strategies that employ short selling, borrowing and leverage, such as long/short equity, long/short credit, market neutral and managed futures, have been available only to institutional and accredited investors. Canadian retail investors will now benefit from access to these alternative investment strategies to diversify their portfolios and protect against downside risk.

The increased choice to invest in alternative products will better enable retail investors to meet their financial goals by reducing market risk through risk-adjusted returns that are non-correlated to the traditional equity and fixed income markets – which is especially important as we may be near the end of the economic cycle and investors may no longer be able to rely on bonds to deliver non-correlated returns in the current interest rate environment.

While this is a moment for celebration, there is still more work to be done, with further advocacy on suitable product risk ratings and continuing education on the role of performance fees in aligning the interests of managers and investors and the benefits of allocating to alternatives, for retail advisors and investors alike. AIMA Canada is committed to continuing to champion these initiatives, leveraging our local expertise and global leadership.

AIMA Canada expects that the final rules relating to alternative mutual fund products will continue to evolve over the next several years as both regulators and the industry become more familiar with the types of investment strategies that can potentially be employed by alternative mutual funds. AIMA Canada will continue to advocate these developments and be a proactive voice for the Canadian alternative mutual fund industry in helping to craft a flexible regulatory framework that will promote innovation and growth in order to provide Canadian investors with a suite of investment products that will help them realize their investment goals.

As you consider beginning or continuing your alternative investment journey, our vibrant community of members can offer knowledge, guidance and support. We look forward to working with you and impacting the alternative investment landscape in Canada for years to come.

Sincerely,

A handwritten signature in black ink, appearing to read "Belle Kaura". The signature is fluid and cursive, with a long horizontal stroke at the end.

Belle Kaura



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AIMA Canada & Scotiabank Alternative Mutual Fund Market Impact Report



By: Claire Van Wyk-Allan,
CAIA

Director, Head of Canada,
AIMA



The alternative investment industry is no stranger to innovation. This is certainly the case in Canada, amidst the innovative institutional investors, dynamic wealth management services, and a robust banking sector. In the retail advisor channel, it is truly an exciting time for Canada's hedge fund industry as the final rules to NI 81-102 allowing alternative mutual funds have officially been released.

While institutions, family offices, and accredited high-net-worth individuals (HNWIs) have been investing in alternative investments for many years, the addition of alternative mutual funds will be transformational for the retail industry. Under this new legislation, Canadian advisors will have greater access to products that can help demonstrate their value to clients, especially as legislation like CRM2 brings advisor fee discussions to the forefront. Retail investors will be able to access the diversification, risk reduction and non-correlated returns that alternative investments provide, especially as we draw closer to the end of the current economic cycle amid a rising interest rate environment.

The AIMA Canada and Scotiabank Alternative Mutual Fund Handbook provides key data on advisor adoption, product launches and the challenges the alternatives industry continues to face, regardless of fund structure. Included in this handbook are the results of a nationwide survey we held to understand how the industry is likely to react to the new legislation and received over 100 responses from fund managers, service providers and investment advisors.

Key findings from the survey:

Allocation & Adoption Trends

The purpose of the survey was to provide data to help quantify the impact of alternative mutual funds to the alternative investment industry in Canada. It hoped to learn what the current appetite is for launching liquid alternative funds under these amendments, as well as the interest by investment advisors to purchase these products. Fund managers/manufacturers, service providers and investment advisors participated.

On average, wealth advisors* currently allocate 11% to hedge funds in investor portfolios, mainly for diversification, risk reduction and/or non-correlated returns. On average, wealth advisor respondents predict 9% of their portfolios going to alternative mutual funds, though notably 22% say as much as one quarter of their portfolio could be allocated to these strategies. Equity long/short is the preferred strategy for current and

projected allocations; long/short credit, market neutral equity and multi-strategy funds follow closely behind [Table 1].

To put this in context, at the end of 2017, 40 Act Funds accounted for US\$250B in the US, and alternative UCITS in Europe accounted for US\$350B (Preqin). At the end of 2017, 35% of advisors reported investing in 40 Act & alternative UCITS structures and another 16% said they planned to do so in the future (Preqin). Some projections put the Canadian alternative mutual fund market at anywhere from C\$20B to C\$100B over the next 5 years (Scotiabank & CIBC).

This disruption may cause an erosion of private hedge fund sales, as a strong majority (81%) of wealth advisors would prefer liquid alts to offering memorandum (OM) products. Almost half of wealth advisor respondents prefer allocating to Canadian managers, while the other half have no preference between a Canadian or a global manager.

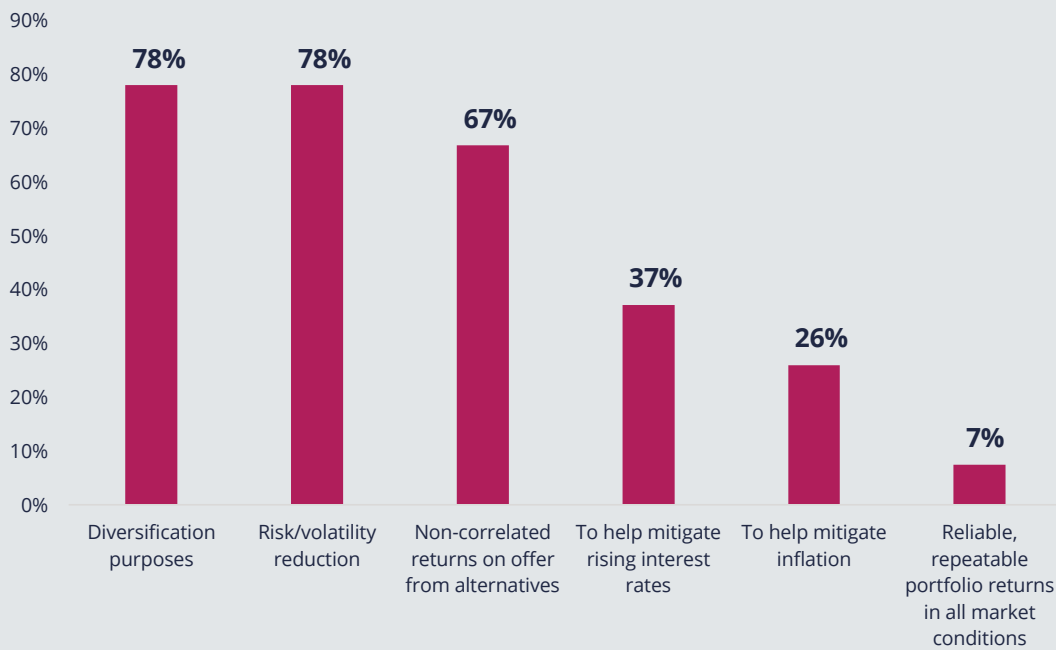
Table 1: Comparing Advisor Allocations to expected launches of Alternative Mutual Fund Strategies

Hedge Fund Strategies Advisors Currently Allocating To	Alternative Mutual Fund Strategies Advisors Would Most Like to Allocate To	Alternative Mutual Fund Strategies Managers most likely to launch, per Managers	Alternative Mutual Fund Strategies Managers most likely to launch, per Service Providers
Equity Long/Short 70%	Equity Long/Short 63%	Equity Long/Short 54%	Equity Long/Short 94%
Multi-strategy 48%	Private Credit 41%	Long/Short Credit 36%	Market Neutral Equity 63%
Market Neutral Equity 41%	Long/Short Credit 37%	Market Neutral Equity 36%	Multi-strategy 63%
Long/Short Credit 30%	Market Neutral Equity 30%	Multi-strategy 21%	Long/Short Credit 50%



Wealth advisors are most likely to allocate to alternatives for diversification and/or risk reduction

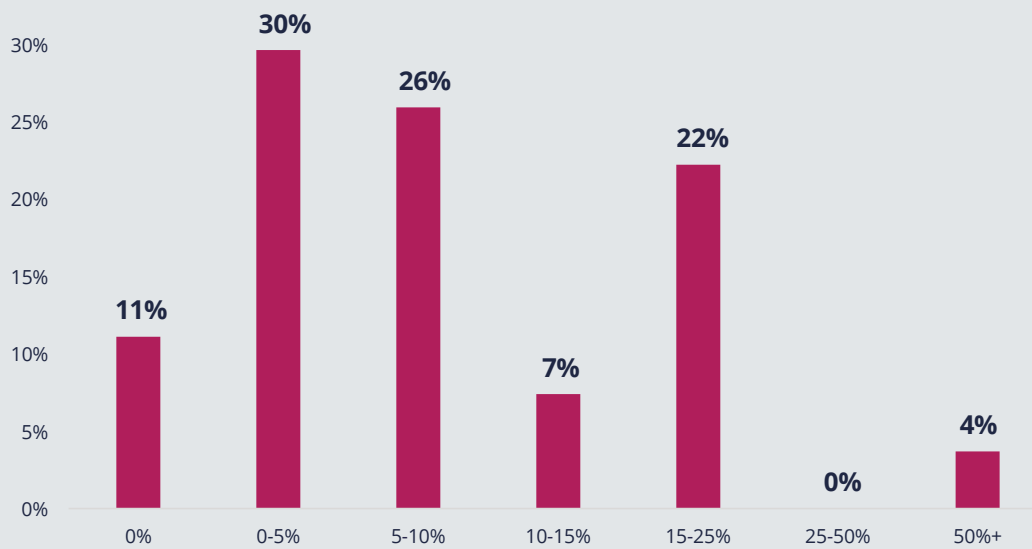
What are the main reasons you (may) allocate to alternative investments? (Select all options that apply)



On average, wealth advisor respondents predict 9% of their portfolios going to liquid Alternative Mutual Funds after the regulatory changes

Were the proposed changes to be enacted, what percentage of your total investor portfolio do you anticipate allocating to liquid alternative funds?

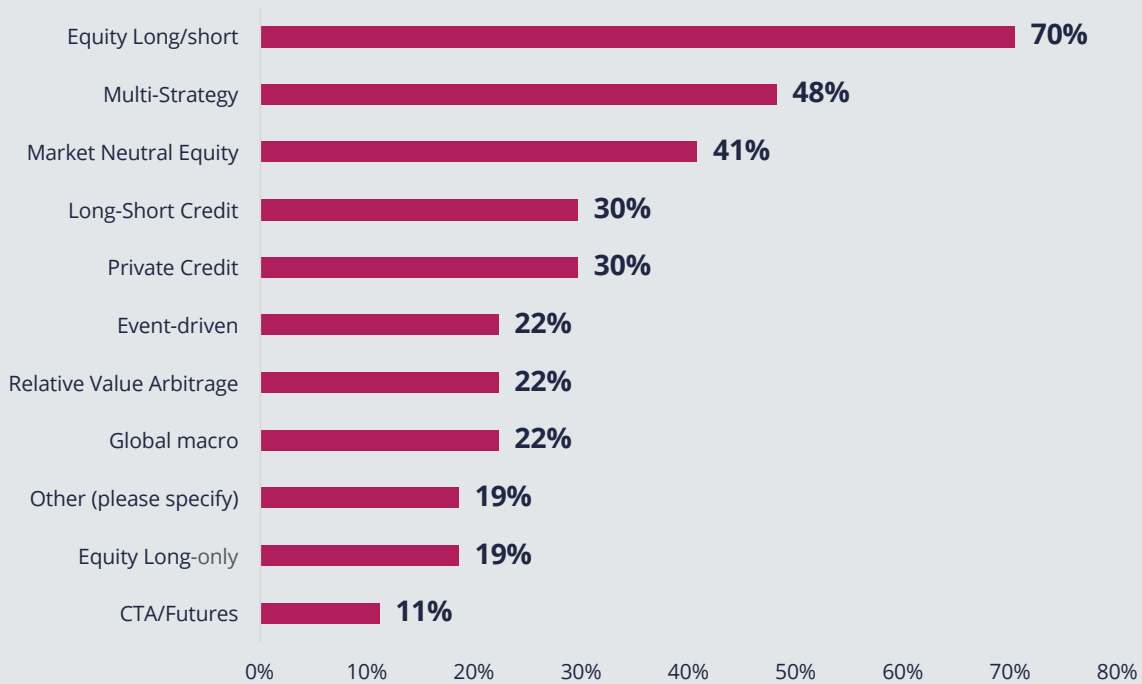
Average: 9%





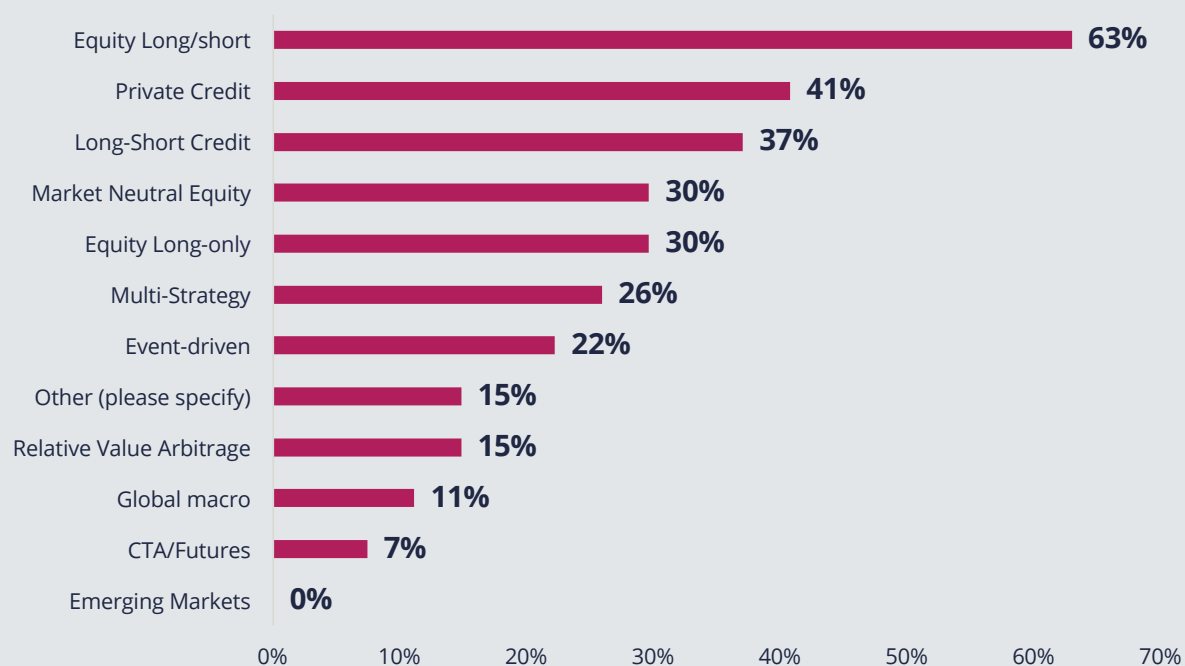
Equity long/short, multi-strategy, and market neutral the most popular hedge fund strategies

**What types of hedge fund strategies are you allocating to?
(Select up to 5 strategies listed below)**



Wealth advisors would be most likely to allocate to equity long/short, private credit, and/or long/short credit should the changes go through

Were the proposed changes to be enacted, what types of liquid alternative strategies do you anticipate allocating to? (Select up to five strategies listed below)





Launch & Adoption Timeline

Many manager respondents** believe the proposed regulatory amendments generally fit with their current strategies, as three quarters are either exploring, planning, or implementing the launch of new fund products. Half of all manager respondents anticipate launching alternative mutual funds within the first year of the final rules being implemented, with the majority of managers planning on managing these alternative mutual funds in-house. Managers expect an average growth in assets under management (AUM) of the magnitude of an additional 14% in the year following the regulatory changes, though others estimate 25% asset growth.

Performance Fees

Almost half of all wealth advisor respondents are uncomfortable with paying performance fees regardless of the fund structure, and another 11% are only comfortable with performance fees on offering memorandum products. As half of manager respondents anticipate launching products with performance fees, this clearly demonstrates the need for greater education on the role that performance fees play in aligning the interests of managers and investors. It also highlights the (perhaps unfair) scrutiny of the Canadian industry on fees.

Education & Understanding

70% of all wealth advisor respondents rate their understanding of alternatives as 'high' or 'very high'. Knowledge gaps persist in the understanding of hedge fund due diligence, associated terminology, nomenclatures and investment strategies. Furthermore, the majority of wealth advisors rate their investors' understanding of alternatives as 'low' or 'very low', which clearly underlines the need for continued educational efforts both for advisor and investors.

Challenges

Among the most popular challenge cited in any adoption of hedge funds is the burden associated with purchasing offering memorandum hedge fund products. Other popularly cited challenges include fees, liquidity, and finally risk-ratings, an issue which will certainly persist in the short-term for alternative mutual fund products as well as dealers become comfortable with new product. Managers considering and/or launching alternative mutual funds are most likely to be hampered by inadequate fund distribution networks and operational burdens when accommodating the regulatory changes.

Advocacy, Education & Looking Ahead

AIMA Canada has been at the forefront of this industry disruption since the beginning of the proposals in 2013, having participated in multiple conversations with the CSA regulators and submitted formal comment letters. This work will continue, as we anticipate this structure will evolve over time (as did alternative UCITS in Europe) as alternative investments become a common part of the average investor portfolio.

To facilitate understanding, implementation and adoption of this new legislation, AIMA Canada offers the below suite of resources.

- a shortened Retail DDQ for dealer head offices, including a Liquid Alt DDQ module
- a one-page DDQ for advisors
- continuing education credit presentation on alternative strategies and the benefits of adding them to a portfolio
- a risk rating guideline paper for dealer head offices
- a recorded webinar on the final NI 81-102 rules
- this Handbook on Launching Alternative Mutual Funds

AIMA looks forward to supporting your alternative mutual fund launch journey with continued guidance, advocacy, advisor & industry education and prominent media communication.

*Majority of wealth advisor respondents are IIROC, Majority of wealth advisor respondents have book AUM of less than \$250M, Average investor size of wealth advisor respondents is slightly under \$1M

**Majority of manager respondents manage alternatives, investment manager respondents manage over \$1B in assets

^Majority of service provider respondents are prime brokers, then fund administrators, then legal.

Background of Alternative Mutual Fund Rules and AIMA Canada's Role



By: **Michael A. Burns**
 Partner, McMillan LLP
 Chair, AIMA Canada Executive
 Committee, 2014-2018

mcmillan

The alternative mutual fund amendments (the "**Final Rules**") to National Instrument 81-102 – Investment Funds ("**NI 81-102**") represent the final phase of the Canadian Securities Administrators' ("**CSA**") Modernization of Investment Fund Product Regulation Project (the "**Modernization Project**") which commenced in 2012. The mandate of the Modernization Project was to review the parameters of product regulation that apply to Canadian publicly offered investment funds (both mutual funds and nonredeemable investment funds) and to consider whether the CSA's current regulatory approach sufficiently addresses investment product and market developments and whether it continues to adequately protect investors.

Phase 1 of Modernization Project

In Phase 1, the CSA focused primarily on publicly offered conventional (primarily long only) mutual funds, codifying exemptive relief that had been frequently granted in recognition of market and product developments. As well, amendments were made in order to keep pace with developing global standards in mutual fund product regulation, notably introducing asset maturity restrictions and liquidity requirements for money market funds.

Phase 2 of Modernization Project – First Stage

In the first stage of Phase 2, the CSA introduced core investment restrictions and fundamental operational requirements for non-redeemable investment funds. Enhanced disclosure requirements were also introduced regarding securities lending activities by investment funds to better highlight the costs, benefits

and risks, and keep pace with developing global standards in the regulation of these activities.

Phase 2 of Modernization Project – Second Stage – The Proposed Alternative Fund Amendments

The CSA first published an outline of a proposed regulatory framework for alternative funds (the "**Alternative Funds Concept Proposal**") on March 27, 2013 as part of Phase 2 of the Modernization Project. In describing the proposed alternative funds regime, the CSA did not publish proposed rule amendments. Instead, a series of questions were asked that focused on the broad parameters for such a regulatory framework (the "**Consultation Questions**").

The Alternative Funds Concept Proposal addressed issues such as: (i) naming conventions; (ii) proficiency standards for dealing representatives; and (iii) investment restrictions for alternative funds.



The CSA also proposed a number of areas where alternative investment funds could be permitted to use investment strategies or invest in asset classes that were not specifically permitted for mutual funds and non-redeemable investment funds under NI 810-102, subject to certain upper limits.

AIMA Canada formed a member task force consisting of alternative investment fund managers (both large and small), custodians, prime brokers, fund administrators, audit and law firms to study the Alternative Funds Concept Proposals and to respond to the Consultation Questions. AIMA Canada's Comment Letter on the Alternative Funds Concept Proposal was submitted on August 23, 2013 along with 54 other commentators.

On February 12, 2015, the CSA published Staff Notice 81-326 Update on an Alternative Funds Framework for Investment Funds, where the CSA briefly described some of the feedback received in connection with the Consultation Questions.

On September 22, 2016, the published for comment amendments (the "**Proposed Amendments**") to NI 81-102 and related National Instruments which sought to codify a number of the parameters and proposals set out in the Alternative Funds Concept Proposal, as well as commentary received in connection with the Proposal. The Proposed Amendments were published for a 90 day comment period, and included a series of consultation questions intended to focus commentary on certain parts of the Proposed Amendments for which the CSA sought specific feedback or commentary.

AIMA Canada's member task force conducted a three month in-depth review of the Proposed Amendments and engaged in extensive consultation with AIMA Canada's members as well as AIMA chapters in the United Kingdom, United States and Australia where similar liquid alternative fund regimes had been in place for some time. AIMA Canada's comment letter on the Proposed Amendments was submitted on December 22, 2016 along with 40 other comment letters.

In the period between December 22, 2016 and October 4, 2018 (the publication date of the Final Rules) AIMA Canada consulted on several occasions with members of the CSA to review the recommendations in AIMA Canada's Comment Letter and suggested changes to the Proposed Amendments. These consultations often involved AIMA Canada members who provided invaluable information to the CSA regarding market practice relating to alternative investment funds not only in Canada, but around the world.

Both the Proposed Amendments and the Final Rules reflect many of AIMA Canada's recommendations provided in our Comment Letters and throughout the consultation process. The CSA is to be commended for thoughtful manner in which they welcomed input from industry participants and the balance that the Final Rules represent in both encouraging innovation in the publicly offered investment fund market and protecting the interests of investors.

AIMA Canada expects that the Final Rules relating to alternative mutual fund products will continue to evolve over the next several years as both regulators and the industry become more familiar with the types of investment strategies that can potentially be employed by alternative mutual funds. AIMA Canada will continue to monitor these developments and be a proactive voice for the Canadian alternative mutual fund industry in helping to craft a flexible regulatory framework that will promote innovation and growth in order to provide Canadian investors with a suite of investment products that will help them realize their investment goals.

Summary of Final Version of Alternative Mutual Fund Amendments

By: **Michael A. Burns**
 Partner, McMillan LLP
 Chair, AIMA Canada Executive
 Committee, 2014-2018



The final alternative mutual fund amendments to NI 81-102 (the “Final Rules”) published by the Canadian Securities Administrators (the “CSA”) on October 4, 2018 (with an expected effective date of January 3, 2019) have made several noteworthy modifications to the originally proposed amendments to NI 81-102 published in September, 2016 (the “2016 Proposed Amendments”). These changes include:

- (a) this new category of investment funds will be known as “alternative mutual funds” as opposed to “alternative funds” and the definition of an “alternative mutual fund” has been slightly modified;
- (b) the 10% single issuer concentration limit for short sale transactions will not apply to the short sale of “government securities”;
- (c) alternative mutual funds and non-redeemable investment funds will be permitted to borrow from both domestic and foreign entities that qualify to act as custodian or a sub-custodian under NI 81-102. The 2016 Proposed Amendments contemplated that borrowing would only be permitted from Canadian entities;
- (d) the overall leverage limit for alternative mutual funds will remain at 300% of net asset value (“NAV”) but the calculation of leverage will exclude the notional value of derivatives used for “hedging” purposes;
- (e) the requirements for entities to qualify to act as custodian or a sub-custodian of an investment fund have been amended to remove the requirement for affiliates of domestic and foreign banks and trust companies to have publicly available financial statements reflecting the required amount of equity (although audited statements evidencing the required amount of equity will still be required);
- (f) alternative mutual funds and non-redeemable investment funds will be permitted to deposit portfolio assets with a value of up to 25% of NAV with a single borrowing agent (other than the custodian or a sub-custodian of the fund) as collateral for short sale transactions as compared to the original 10% of NAV limit in the 2016 Proposed Amendments; and
- (g) National Instrument 81-104 (formerly named Commodity Pools) (“NI 81-104”) will continue in force only as it relates to the proficiency requirements for mutual fund dealers distributing alternative mutual funds and will be renamed “Alternative Mutual Funds”



A more in-depth examination of the Final Rules is set out below.

Definition of “Alternative Mutual Fund” and Naming Convention

An “alternative mutual fund” is defined in the Final Rules 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.”

The definition is intentionally broad in scope and is similar to the definition of “commodity pool” previously found in NI 81-104. The definition was altered from the 2016 Proposed Amendments to specifically exclude precious metals funds, which are now separate category of investment fund under NI 81-102.

The Final Rules do not prescribe a naming convention. An alternative mutual fund is not required to utilize or incorporate the word “alternative” or any other term signalling that the fund is an alternative mutual fund in its name. However, in contrast, conventional mutual funds and non-redeemable investment funds should refrain from using the word “alternative” in their names.

Concentration Restrictions

Alternative mutual funds must restrict investments in any one issuer to a maximum of 20% of NAV of the fund at the time of purchase (in comparison to 10% for conventional mutual funds). This 20% concentration limit does not apply to the purchase of certain securities,¹ including “government securities” (as defined in NI 81-102).

Non-redeemable investment funds, which previously had no concentration restrictions, are now also subject to this 20% limit under the Final Rules.

Investments in Physical Commodities

Alternative mutual funds are exempt from the restrictions relating to investments in physical commodities that apply to conventional mutual funds under the Final Rules. Non-redeemable investment funds also continue to be exempt from these restrictions.

Under the Final Rules, conventional mutual funds, which were previously restricted to investing in gold, are now permitted to invest (directly or indirectly through specified derivatives) in gold, silver, palladium and platinum, subject to an overall limit 10% of NAV. A “look through” test has also been introduced for measuring compliance by a conventional mutual fund with the 10% of NAV limit in relation to fund-of-fund investments. These changes reflect exemptive relief that has been regularly granted to mutual funds and recognizes that physical commodities represent an asset class that can be used effectively within a diversified investment portfolio.

Illiquid Assets

Investments by alternative mutual funds in illiquid assets are limited to 10% of NAV after purchase and a hard cap of 15% of NAV at any time. This same restriction currently applies to conventional mutual funds.

Non-redeemable investment funds, which have previously not been subject to any restrictions, will be subject to a limit on investing in illiquid assets of 20% of NAV at the time of purchase with a hard cap of 25% of NAV at any time. This may represent a significant change for non-redeemable investment funds that have a particular focus on illiquid assets.

The Final Rules make no substantive change to the definition of “illiquid assets”² in NI 81-102 and, as a result, may not capture certain assets that may be of interest to alternative mutual fund managers. The CSA may consider changes to the definition of illiquid assets in the future as part of a separate project.

¹Section 2.1(2) of NI 81-102 states that the 20% concentration limit does not apply to the purchase of any of the following: (a) a government security; (b) a security issued by a clearing corporation; (c) a security issued by an investment fund if the purchase is made in accordance with the requirements of section 2.5 of NI 81-102; (d) an index participation unit that is a security of an investment fund; and (e) an equity security if the purchase is made by a fixed portfolio investment fund in accordance with its investment objectives.

²“illiquid asset” means (a) a portfolio asset that cannot be readily disposed of through market facilities on which public quotations in common use are widely available at an amount that at least approximates the amount at which the portfolio asset is valued in calculating the net asset value per security of the investment fund, or (b) a restricted security held by an investment fund. A “restricted security” means a security, other than a specified derivative, the resale of which is restricted or limited by a representation, undertaking or agreement by the investment fund or by the investment fund’s predecessor in title, or by law.

Cash Borrowing

Alternative mutual funds will be permitted to borrow cash up to an amount equal to 50% of NAV. Cash borrowing is only permitted from entities that qualify as an investment fund custodian or sub-custodian under sections 6.2 or 6.3 of NI 81-102. This essentially restricts borrowing to Canadian and foreign banks and trust companies (or their qualified dealer affiliates) and represents an important change from the 2016 Proposed Amendments which had restricted cash borrowing to Canadian financial institutions.

Where the lender is an affiliate of the alternative mutual fund's investment manager, approval of the fund's independent review committee is required under National Instrument 81-107 *Independent Review Committee for Investment Funds*.³

Any borrowing agreements entered into with an affiliate of the Fund's manager must be in accordance with normal industry practice and be on standard commercial terms for agreements of this nature.

Non-redeemable investment funds, which currently have no borrowing restrictions, will be subject to the same borrowing restrictions applicable to alternative mutual funds.

No changes have been made to the borrowing restrictions applicable to conventional mutual funds in the Final Rules.

Short selling

Alternative mutual funds will be permitted to engage in the short selling of securities up to a limit of 50% of NAV (compared to 20% for conventional mutual funds and 40%, pursuant to exemptive relief, for currently existing commodity pools). In order to facilitate long/short strategies, alternative mutual funds will not be required to maintain cash cover for short positions and will be permitted to use the proceeds of short sales to purchase other securities.

Alternative mutual funds are generally subject to a 10% of NAV limit on the short selling of securities of single issuer (in comparison to 5% for conventional mutual funds). However, in a notable change from the 2016 Proposed Amendments, the 10% limit will not apply to the short sale of "government securities" by an alternative mutual fund.

³Amendments have been made to section 5.2 of NI 81-107 to codify this requirement.

Non-redeemable investment funds are subject to the same short selling restrictions as alternative mutual funds.

Another important change from the 2016 Proposed Amendments was made in section 6.8.1 of NI 81-102 to the limit on portfolio assets that may be deposited as collateral with a borrowing agent (other than the custodian or a sub-custodian) in connection with short selling transactions. This limit was increased to 25% of NAV for alternative mutual funds (or non-redeemable investment funds) from the 10% of NAV limit specified in the 2016 Proposed Amendments and will provide much needed flexibility for funds in making arrangements with counterparties for the short sale of securities.

Combined Limit on Borrowing and Short Selling

The aggregate of all cash borrowing and exposure under short selling transactions for alternative mutual funds and non-redeemable investment funds is limited to 50% of NAV. This limit is unchanged from the 2016 Proposed Amendments.

Use of Specified Derivatives

Under the Final Rules, unlike conventional mutual funds, alternative mutual funds are permitted to use specified derivatives (directly or indirectly) for investment purposes or to create synthetic leverage. Previously, only commodity pools were permitted to create leverage using specified derivatives.

Derivative Counterparty Requirements & Exposure Limits

The Final Rules codify discretionary relief previously granted to conventional mutual funds in order to permit compliance with the Dodd-Frank Wall Street Reform and Consumer Protection Act in the United States and comparable legislation in Europe relating to the mandatory use of the facilities of sanctioned clearing corporations for facilitating trade of over-the-counter (OTC) derivatives. This codification applies to all investment funds subject to NI 81-102.

Unlike conventional mutual funds which were required to deal with counterparties that had a "designated rating" (generally, a rating of "A" or higher for the counterparty's long-term debt), alternative mutual funds will be exempt from this requirement, enabling them to enter into OTC derivatives transactions with a wider variety of counterparties



(i.e. counterparties that do not have a designated rating). The ability to transact with a broader array of potential counterparties will benefit alternative mutual funds in terms of pricing and products.

However, alternative mutual funds cannot entirely ignore the credit rating of their derivatives counterparties. In a change from the 2016 Proposed Amendments, alternative mutual funds and non-redeemable investment funds will be permitted to exceed the 10% of NAV mark-to-market limit on specified derivatives exposure to a single counterparty if the counterparty has a designated rating.

The new derivatives regime reflected in the Final Rules represents an ideal compromise between the existing rules for conventional mutual funds (which include both a creditworthiness test and exposure limits) and commodity pools (which include a creditworthiness test but no exposure limits). Unlike conventional mutual funds, alternative mutual funds and non-redeemable investment funds will not be required to ensure that a counterparty meets the regulatory creditworthiness test, provided that the exposure to such counterparty is maintained at less than 10% of NAV. However, if a counterparty has a designated rating, alternative mutual funds will have the flexibility to obtain greater exposure to such counterparty.

Aggregate Leverage Limit

The aggregate limit on the use of leverage by an alternative mutual fund through the use of cash borrowing, short selling and the use of specified derivatives remains at 300% of NAV, unchanged from the 2016 Proposed Amendments. However, the formula for the calculation of an alternative mutual fund's gross exposure has been modified.

In determining the aggregate exposure, a fund must add up the following and divide the sum by its NAV:

- (a) the value of any outstanding loans;
- (b) the market value of all short positions; and
- (c) the aggregate notional value of the fund's specified derivatives positions, **minus the notional value of those specified derivatives positions that are "hedging" (as defined in NI 81-102) transactions** (emphasis added).

The ability for alternative mutual funds to deduct the notional value of specified derivatives used for hedging purposes will more accurately reflect the true amount of leverage utilized in the fund's investment strategies as hedging transactions generally act to reduce rather than increase leverage.

It should be noted that the aggregate leverage limit includes exposure gained by the alternative mutual fund from investments in underlying alternative mutual funds that may also employ leverage (i.e. a "look through" test is employed to determine aggregate leverage).

The aggregate leverage limit must be calculated as of any day on which the fund calculates its NAV (which, in most cases, is daily). In the event that the leverage limit is exceeded, the fund must, as quickly as commercially reasonable, take all necessary steps to appropriately reduce the exposure.

The 300% of NAV limit of leverage is a departure from the previous commodity pool rules, which contained no limits on notional exposure.

Non-redeemable investment funds will be subject to the leverage limit of 300% of NAV under the Final Rules but will be provided with an extended transitional period in order to comply with this requirement.

Specific disclosure is required in the alternative mutual fund's simplified prospectus and fund facts⁴, or a non-redeemable investment fund's prospectus, as applicable, as well as in financial statements regarding the use of leverage by the fund.

Fund-on-Fund Investments

Conventional mutual funds will be able to invest up to: (i) 100% of NAV in any other mutual fund, including ETFs, other than alternative mutual funds; and (ii) 10% of NAV in alternative mutual funds and non-redeemable investment funds provided that, in each case, the underlying fund is subject to NI 81-102.

The fund-on-fund investment provisions in NI 81-102 have the potential to significantly increase demand for alternative mutual funds, given that conventional mutual funds in Canada have approximately \$1.5 trillion in assets.

⁴Alternative funds listed on an exchange will be required to use a long form prospectus and ETF facts.

Alternative mutual funds will be able to invest up to 100% of their NAV in any other mutual funds (including alternative mutual funds) or non-redeemable investment funds provided the underlying fund is subject to NI 81-102.

The Final Rules remove the restriction that a top fund may only invest in an underlying fund that is a reporting issuer in the same jurisdiction (province or territory) as the top fund. Instead, a top fund may invest in an underlying fund as long as the underlying fund is a reporting issuer in at least one Canadian jurisdiction.

The Final Rules do not modify the fund-of-fund provisions for non-redeemable investment funds.

All investment funds are prohibited from investing in investment funds that are not reporting issuers (i.e. private funds).

Redemptions and NAV Calculation

Alternative mutual funds will be permitted to redeem an order for securities of the fund at a price that is equal to the NAV of such securities determined on either the first or second business day after the date of receipt of the redemption order provided that: (i) the fund has established a policy providing for the redemption price to be calculated on such a basis; and (ii) the policy has been disclosed in the fund's simplified prospectus prior to the implementation of the policy.

Alternative mutual funds will be required to pay the proceeds of redemption by no later than 15 business days after the valuation date on which the redemption price for the securities was determined.

Alternative mutual funds will be permitted to suspend redemptions for a period of six months from the date on which receipt is issued for the initial simplified prospectus of the fund provided that this is disclosed in the prospectus. We do not expect that this option will be relied upon by many alternative mutual funds as it would likely be considered as a deterrent to sales.

Incentive (Performance) Fees

Unlike conventional mutual funds, which may only charge incentive fees which are calculated in relation to a reference benchmark or index, alternative mutual funds will have much greater latitude in the formulation and calculation of any incentive fee charged to the fund.

The method of calculating the incentive fee must be disclosed in the simplified prospectus of the alternative mutual fund and the payment of any incentive fee must be based on the cumulative total return of the fund for the period that began immediately after the last period for which an incentive fee was paid (i.e. the incentive fee is subject to a permanent "high water mark").

Offering and Point of Sale Documents

Alternative mutual funds will generally be offered in the same manner as conventional mutual funds. Alternative mutual funds not listed on a stock exchange will be subject to the same disclosure regime as conventional mutual funds under NI 81-101 - Mutual Fund Prospectus Disclosure, which includes the preparation of a simplified prospectus and annual information form as well as a fund facts document for each class or series of units of the fund that is delivered to investors at the point of sale.

While multiple investment funds can normally be combined in the same simplified prospectus, the simplified prospectus for an alternative mutual fund is not permitted to be combined with the simplified prospectus for a conventional mutual fund in order to avoid potential confusion.

Alternative mutual funds will be required to include prescribed textbox disclosure in the fund facts document stating that the fund is an alternative mutual fund under NI 81-102, how its strategies differ from conventional mutual funds and include additional disclosure regarding lenders (if the alternative mutual fund intends to borrow cash) as well as the use of leverage.

Non-redeemable investment funds, alternative mutual funds that are listed on an exchange and ETFs will have to be offered through a long form prospectus and an ETF Facts document (in the prescribed format).



Proficiency and Distribution

The securities of alternative mutual funds must generally be distributed through dealers that are members of the Investment Industry Regulatory Organization of Canada (“IIROC”). For IIROC dealers, the proficiency requirements are addressed in subsection 3.4(1) of National Instrument 31-103 Registration Requirements, Exemptions and Ongoing Registrant Obligations (“NI 31-103”), which states that:

“[a]n individual must not perform an activity that requires registration unless the individual has the education, training and experience that a reasonable person would consider necessary to perform the activity contemplated”.

Canadian mutual fund dealers will generally not be permitted to distribute securities of alternative mutual funds unless they meet the proficiency requirements that remain in NI 81-104. These requirements (which are currently applicable to the distribution of the securities of commodity pools) provide that the mutual fund restricted dealer representative must have one of the following qualifications:

- (a) a passing grade for the Canadian Securities Course;
- (b) a passing grade for the Derivatives Fundamentals Course;
- (c) successfully completed the Chartered Financial Analyst Program; or
- (d) obtained any applicable proficiency standard mandated by a self-regulatory authority.

The CSA is currently engaged in an ongoing initiative in relation to dealer-focused issues. It is generally anticipated that any significant changes relating to dealer proficiency standards will be addressed as part of these efforts. The CSA is expected to repeal NI 81-104 in its entirety once an appropriate replacement for mutual fund dealer proficiency standards is in place.

Exempt market dealers are not permitted to distribute securities of alternative mutual funds offered under a simplified prospectus.

Custodial Arrangements

Alternative mutual funds will be required to appoint a single Canadian custodian but may also have one or more sub-custodians who hold assets of the fund. For portfolio assets that are held in Canada, the custodian or sub-custodian must meet the qualifications set out

in section 6.2 of NI 81-102. For portfolio assets held by a sub-custodian outside of Canada, the sub-custodian must satisfy the requirements in section 6.3 of NI 81-102.

The Final Rules have modified the requirements for affiliates of domestic and foreign banks or trust companies to qualify as custodian or sub-custodians under sections 6.2 and 6.3 of NI 81-102. These entities are no longer required to have **publicly available** (emphasis added) audited financial statements showing at least the minimum required amount of equity (although audited statements will still be required).

This change means that most bank-owned prime brokers in Canada and abroad will likely qualify to act as custodian or a sub-custodian (as applicable) of a Canadian publicly offered investment fund thereby providing greater flexibility for alternative mutual funds and non-redeemable investment funds in structuring their custodial and prime brokerage arrangements.

Continuous Disclosure

Alternative mutual funds will be subject to the same ongoing disclosure requirements as conventional mutual funds and other prospectus qualified investment funds, which include (by way of example) preparation and delivery of annual audited and semi-annual unaudited financial statements, management reports of fund performance, annual information forms and timely disclosure of material changes.

Seed Capital and Organizational Costs

Alternative mutual funds will have minimum seed capital requirements of \$150,000, the same as conventional mutual funds. The seed capital investment may be redeemed once the alternative mutual fund has raised at least \$500,000 from outside investors. This is a departure from the seed capital requirements previously applicable to commodity pools, which required the manager to maintain a minimum of \$50,000 in seed capital for the life of the commodity pool.

Managers of alternative mutual funds will not be entitled to receive reimbursement from the fund for any organizational costs incurred in connection the establishment and preparation of the initial offering documents of the fund (as is currently the case with conventional mutual funds). In contrast, managers of non-redeemable investment funds and ETFs that are not in continuous distribution will continue to be able to pass on organizational costs to the funds.

If an alternative mutual fund is distributed in Québec, the fund will have an added cost of translating its offering documents into the French language.

Restrictions on Sales Commissions and Marketing Practices

Alternative mutual funds will be subject to National Instrument 81-105 Mutual Fund Sales Practices. Among other restrictions, sales commissions cannot be charged to the fund and must be paid by the manager.

Security holder and Regulatory Approval of Fundamental Changes

The current provisions of NI 81-102 that apply to all investment funds regarding fundamental changes (events requiring security holder approval) will also apply to alternative mutual funds. A change in the basis of calculating fees, fee increases, changes in the fundamental investment objectives of the fund or reorganizations, among other things, require security holder approval. In addition, the costs associated with any reorganization of the fund may not be borne by the fund.

Furthermore, regulatory approval is required in the event of, among other things, a change in the manager of the alternative mutual fund (other than to an affiliate) or a change of control of the manager.

Effective Date and Transition Period

As noted above, the Final Rules are currently expected to come into force on January 3, 2019 (the “**Effective Date**”). The CSA has provided existing commodity pools a transition period that expires on July 4, 2019 to make any necessary operational changes in order to comply with the Final Rules. Existing non-redeemable investment funds will also be exempted from certain of the investment restrictions in the Final Rules subject to certain conditions.

Voluntary Transition to an Alternative Mutual Fund

In contrast to a commodity pool, which will be designated as an alternative mutual fund under the Final Rules as of the Effective Date, an existing non-redeemable investment fund may elect to transition into an alternative mutual fund. However, there may be practical challenges with such a transition, including: (i) the holding of a meeting of unitholders of the fund to obtain unitholder approval, as the transition would likely constitute a change in fund’s fundamental investment

objectives or restrictions; (ii) amendments to the constating documents of the fund; and (iii) changes to the custodial arrangements of the fund (if necessary).

Existing conventional mutual funds may also elect to transition into alternative mutual funds, but they would encounter similar challenges.

Limits of Final Rules

Although the Final Rules significantly broaden the range of investment strategies that can be offered to retail investors, there remain certain strategies that would not be permitted under the Final Rules. For example, the limit on short selling (50% of NAV) does not allow a “pure” 100% long/short market neutral strategy to be implemented. In addition, the total leverage limit of 300% of NAV may restrict some managed futures strategies.

The CSA have indicated that they will consider applications for exemptive relief from the requirements of the Final Rules to potentially accommodate investment strategies which may not work within these parameters.

Opportunities for Growth

The Final Rules will create significant opportunities for Canadian alternative managers to expand their business. For many years, mutual fund rules in Europe and the United States have been more flexible than those in Canada. Under the Final Rules, Canadian managers will now be able to offer a wide variety of alternative investment strategies to Canadian retail investors and such investors will benefit from access to a new suite of investment products to help meet their financial goals.

The Final Rules will also open the door for foreign-domiciled fund managers to offer their investment funds at a retail level in Canada. This could be accomplished either through: (i) the foreign manager obtaining the necessary registrations in Canada to manage and advise a Canadian domiciled alternative investment fund; or (ii) entering into a sub-advisory arrangement with a Canadian fund company.



5

A Checklist for Alternative Investment Fund Managers

By: **Michael A. Burns**
Partner, McMillan LLP
Chair, AIMA Canada Executive
Committee, 2014-2018



- ✓ Consider which strategies can be conducted under the proposed investment restrictions for alternative funds. Could you offer new strategies as alternative funds?
- ✓ Consider whether existing private funds could be prospectus qualified under the new rules or whether newly created funds would be preferable.
- ✓ Review your business plan filed in connection with your existing securities registrations to ensure it covers offering alternative funds to the public.
- ✓ Review your existing material contracts to determine if they require amendment for alternative funds.
- ✓ Consider whether you need to develop relationships with additional service providers (e.g. administrators, transfer agents).
- ✓ Examine existing custody and prime brokerage arrangements to determine if changes are necessary for new alternative funds (currently the custodian requirements in NI 81-102 do not allow most prime brokers to custody assets).
- ✓ Consider distribution channels for alternative funds and open dialogue to get alternative funds approved by dealers.
- ✓ Review sales and marketing practices to ensure they comply with National Instrument 81-105 Mutual Fund Sales Practices.
- ✓ Consider any potential conflict of interest which may arise for the manager with alternative funds.
- ✓ Prepare for establishing an independent review committee as required for all public investment funds to review conflicts of interest with the manager.
- ✓ Review internal policies and procedures and compliance manual; make any amendments or adopt additional policies and procedures as may be required to offer retail funds.
- ✓ Consider how the new risk classification rules will apply to alternative funds to ensure that any proposed alternative funds will be able to calculate and disclose risk.

6

Enlisting a Full-Service Prime Broker



By: Daniel Dorenbush,
MBA, CFA

Managing Director,
Head of Canadian Prime Services,
Scotiabank, Global Banking
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PBs will also be adjusting to a new counterparty type, Liquid Alternatives, which will place new demands on them that differ from those of a traditional alternative or long-only asset managers

PBs will be accustomed to the general strategies employed by Liquid Alternative funds; however the regulated nature of the entities will present some new issues for brokers to keep in mind:

Enhanced Reporting Requirements:

Regulated mutual funds are required to adhere to more stringent and frequent reporting. Increased regulatory reporting requirements and the need to publish daily NAVs will place greater demands on PBs and Administrators for timely and comprehensive statements of activity.

PB Learning Curve:

For some managers, Liquid Alternatives will be their first foray into a PB relationship. It is essential for PBs to cultivate strong working partnerships with managers as they learn the intricacies of PB operations. PBs with well-developed platforms and experienced personnel will be best-positioned to provide the initial level of support required by a Liquid Alts manager.

An Important Choice - Selecting a PB:

PBs serve as key partners for fund managers, providing the following services which are required to successfully execute a liquid alternative fund strategy. The ability of a PB to provide these services in a consistent and proficient manner can have a direct impact on a fund's overall performance:

- Facilitating short positions through stock borrow and lending.
- Providing margin financing.
- Acting as the derivative financing counter-party to swap transactions for equity and credit exposure.
- Clearing and settling trades from dealers globally.
- Back-office services such as corporate actions processing, reporting etc.



Prime Broker Selection Process

There are several important factors that should be examined when selecting a PB for a Liquid Alternative Mutual Fund:

Market access:

A key distinguishing factor for a PB is their ability to clear, settle, and finance securities and/or derivatives in a broad range of international markets. To the extent a manager requires international access their PB should also be able to seamlessly facilitate global trade execution in tandem with global clearing and settlement within a client's PB account. Managers should closely assess a PB's global capabilities to ensure they can support their contemplated strategy.

Securities Lending:

PBs have different levels of access to securities borrowing supply based on size, experience and agent-lender arrangements. The more diversified a PB's lending pool is, the more likely they are to be able to locate a targeted short security at a competitive rate and support borrows for the duration of any given trade.

Balance sheet availability:

A PB needs to have sufficient funding resources – and importantly appetite – to finance a fund's portfolio. Certain strategies place a greater strain on a PB's balance sheet and regulatory capital; both finite resources. As a result, it is important to understand if a potential PB's appetite for funding matches the fund's investment strategy.

Client Service:

A Client Service Rep (CSR) is the key day-to-day point of contact for the Fund at their PB. A Client Service team should have a strong understanding of a Fund's strategy and provide ongoing proactive operational and technology solutions to allow for efficiency and support as the fund grows. Funds should also ensure there is an effective client support model across time zones, in the case of a manager that trades globally and required follow-the-sun CSR support and reporting.

Counterparty Risk:

As with any lending relationship, the counterparty risk of a PB is a key consideration. Risks include credit-worthiness, operational, country, and market risk. Depending on fund size, a multi-prime relationship can diversify counterparty credit risk – provided additional primes have similar financing and operational capabilities.

Pricing:

PBs mainly generate revenue through interest spreads and securities lending and borrowing fees. Understanding a PB's pricing methodology and constraints on their business is an important aspect to discuss when selecting a PB.

Product Selection - Cash Prime Brokerage versus Synthetic Prime Brokerage

Prime Brokerage can be conducted on a "cash" basis – where the fund holds, or shorts, securities directly in the cash market – or on a "synthetic" basis – where swap derivatives are used to replicate the performance of an underlying security.

Depending on a manager's needs at a given point in time, they may require the ability to switch seamlessly between Cash and Synthetic PB. Managers should assess the flexibility of their PB's platform and their ability to support Cash and Synthetic PB in a wide range of global markets simultaneously.

Overall, a broker's ability to facilitate Margin Finance, custody and execution in global markets via both Cash and Synthetic Prime Brokerage is a key factor to consider when selecting a PB. Managers should consider all of the factors listed above in their PB selection process to ensure that a given broker has the ability to grow with a fund and curtail the need to enlist the services of additional PBs later on.

Global Securities Lending

By: Daniel Dorenbush,
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Managing Director,
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The introduction of Liquid Alternative strategies to the Canadian marketplace will require managers to enlist the services of a Prime Broker (PB) to facilitate short equity and fixed income exposure. It is imperative that managers assess the capabilities of a given PB's Securities Borrowing and Lending operation with an emphasis on available supply, international reach and counterparty depth.

The Global Securities Lending market is estimated to have lendable assets in excess of C\$25 trillion (equity and fixed income), approximately C\$3.1 trillion of which are currently on-loan. In Canada, lendable market supply sits at an estimated C\$1.75 trillion in assets with C\$220 billion currently on loan.

Canadian Marketplace

In Canada, like many other countries, the historical setup of the market is that the supply of lendable assets originates primarily from the lending desks of custodian banks. These desks act as principal or agent on behalf of various beneficial owners which are typically pension funds, mutual funds, sovereign wealth funds etc. The demand side is driven by broker-dealer and bank counterparties' demand for short / hedging coverage for its own or clients' accounts. Recently, retail and discount brokers have emerged as a new source of lendable asset supply.

Securities Lending and Borrowing Mechanics

Securities Lending and Borrowing transactions have always been secured, and fully collateralized, at a transaction level. Historically, government bonds or cash were used as the acceptable form of collateral, however as the industry has evolved and the need to minimize balance sheet impact has become prevalent, equities are becoming a more popular and preferred choice of collateral. The natural correlation of an equity versus equity collateralized transaction (with sector diversification etc.) has resulted in an increased acceptance of equities as collateral for borrows.



Potential risks associated with short sales and Securities Lending/Borrowing transactions include recalls, buy-ins and re-rates. Recalls in a specific security can result in a need for the short seller to cover their position, if supply avenues dry up, long beneficial owners are forced to sell their positions. Buy-ins can also occur if the party fails to comply with the recall and deliver the position back to the beneficial owner in a timely manner. The risk in this instance is with an increase in the market price of the buyback, which could occur at any time during the life of the trade.

Re-rates and recalls can result in unanticipated losses for a fund, it is imperative that a manager properly assess the ability of a PB's Securities Lending desk to manage their supply side relationships and minimize the frequency of these events.

Additionally, as the Securities Lending business becomes more mature and transparent with respect to pricing and data analytics, re-rating of fees on open transactions occurs more frequently as lenders are now able to be more responsive to changes in supply and demand of securities based in market events.

Importance of Securities Lending and Borrowing to Liquid Alternative Funds

The overall strength of a Securities Lending desk is an important factor for Liquid Alternative managers to consider when selecting a PB. The breadth of coverage and supply-side counterparty base that a Securities Lending desk can access is key to performing its core function of sourcing securities to support a given fund's short sales. PBs with highly developed and experienced Securities Lending desks will be able to provide the necessary support to managers that are new to alternative strategies.

Managers should focus on a PB's ability to locate securities in a broad range of global markets and maintain borrows for the duration of a trade while simultaneously limiting re-rates and recalls. PBs with larger Securities Lending desks are most likely to have the regional expertise and depth of supply necessary to consistently support the short side of a given manager's Liquid Alternative strategy.

The Importance of education to the growth of Canadian Liquid Alternatives



By: Jeff Ray

Vice President Product
Development at Mackenzie
Investments



Until recently, alternative investments in Canada were only available to institutional investors and accredited (high-net-worth investors). Now, Canada's investment market is opening to liquid alternative funds for retail investors. Regulatory changes are expected to give retail investors more access to liquid alternative investments to help diversify portfolios and increase the potential to achieve higher risk-adjusted returns.

This article will reflect on the rationale for Mackenzie Investments as a traditional long-only global investment firm, to enter the liquid alternatives space from an investor and commercial perspective, and the importance of educating advisors and investors.

Mackenzie Investments built its business as an asset manager primarily focused on traditional, long-only investing. There are several reasons why Mackenzie chose to enter the liquid alternatives area with the launch of the Mackenzie Multi-Strategy Absolute Return Fund. From an investor perspective, Mackenzie believes that investors have plenty of choices to attain market beta. Alternative investments represent an 'alternative' way for investors to diversify their portfolios away from their long-standing reliance on traditional stocks, bonds, and cash. These investments can be used to potentially generate higher returns, to dampen volatility, and to preserve capital over a long-term horizon. As the Canadian population ages, dampening market volatility and preserving capital are paramount to a profitable retirement.

As liquid alternatives become increasingly available within Canada, it is important to recognize that while liquid alternatives may be applicable to many types of investors and portfolios. These investments may have greater applicability to three distinct investor segments.

1. Individual investors who possess an above-average understanding of financial markets and techniques that investment managers use in the construction and management of portfolios. Knowledge is important here, as there is a need on the part of the investor to understand the underlying investments and to be able to have a fact-based discussion with their investment advisor about the merits of an investment in an alternatives-based fund.
2. Liquid alternatives fit well with investors who are focused on specific outcomes such as improving risk-adjusted returns, and greater diversification.



3. Reflecting the overall investment objective of these alternative products, retail investors who have a medium investment horizon or longer will be the ones best-positioned to benefit from the counter-cyclical nature of many of the underlying investments. In other words, investors seeking to invest for a shorter period should consider other mutual funds and ETFs.

From a commercial perspective, Mackenzie looked to the US market where investor demand for liquid alternative mutual funds grew in response to the volatility that followed the global market disruption of 2008–2009. Alternative investments offered institutional and retail investors in the United States the opportunity to diversify away from stock and bond investing and dampen volatility.

They initially invested in less liquid alternatives such as hedge funds and private market funds. However, investors soon realized they faced a major risk by not being able to rebalance quickly and shifted toward “liquid” alternative investments. The growing acceptance of liquid alternative mutual funds among US investors led to a rapid increase in the number of strategies. This prompted investors to look for packaged solutions that allow them to access multiple strategies within the same fund. As of December 2017, assets in US liquid alternatives accounted for USD \$371 billion.

It is important to turn our attention to the importance of education as it relates to the growth of liquid alternatives in Canada. Mackenzie Multi-Strategy Absolute Return Fund was launched in advance of the Alt Fund regulations becoming final, so Mackenzie made a conscious decision to emphasize education in our investor and advisor facing materials.

Mackenzie believes it is critical to highlight the expanded array of investment tools that the portfolio managers of the fund, and alternative funds generally, have at their disposal. This includes a detailed explanation of the use of uncovered derivatives, cash borrowing and greater flexibility to short sell; these can all contribute to leverage which was previously not permitted for retail mutual funds. In addition to highlighting the benefits of these strategies, Mackenzie is also focused on explaining the risks associated with these tools and strategies to advisors and investors. For example, we believe the expansion of the use of short selling without a “cover” requirement warrants a more detailed description of the risks of short selling which we address in our materials.

Mackenzie’s materials include a general educational guide and a strategies spotlight brochure with comprehensive details around the strategies employed by liquid alternatives. We have also produced other investor and advisor materials, including videos that describe each alternative strategy used in the Fund. Mackenzie believes educating the market is critical to the growth of liquid alternatives in the Canadian market. It is also imperative that investors understand the benefits and risks associated with liquid alternatives compared to traditional mutual funds under National Instrument 81-102. For these reasons, we produced more investor and advisor facing materials compared to previous fund launches.

Back-Office Insights on Amendments to National Instrument 81-102



By: **Charbel Cheaib**
Executive Director, Business Development, CIBC Mellon



By: **Ronald C. Landry**
Vice President, Canadian ETF Services, CIBC Mellon

CIBC MELLON

Navigating Canada's New Regulatory Framework for Liquid Alternatives

The Canadian Securities Administrators recently finalized new changes to National Instrument (NI) 81-102, "Investment Funds," which allows for alternatives strategies to be offered under a simplified prospectus. This change offers the possibility of wider distribution of alternatives to the retail market. Readers are encouraged to consult with their legal counsel and other advisors for specific guidance pertaining to your situation.

Investment managers looking to introduce products under the amendments made to NI 81-102, and who had previously distributed exclusively to the exempt market, would need to comply with the requirement of appointing a "qualified" fund custodian. Custodians are required to hold assets separately from their own assets. Overall, there are some key differences for investment managers to consider.

Insights on working with a custodian

In addition to custody, ancillary services are available from a custodian, including performance reporting and compliance monitoring services, and collateral management services. Since a custodian's role is to hold assets apart and to not provide leverage services, investment managers can be free to select any prime broker of their choice.

Alternative fund managers that intend to launch an alternative fund under a simplified prospectus may need to change their custody arrangements as alternative funds would be subject to the custody requirements of NI 81-102 Part 6 – "Custodianship of Portfolio Assets."

Alternative fund managers should be aware that when working with a custodian, there may be additional documentation or operational steps required. Therefore, lead times, monitoring and administration may need to be adjusted accordingly.

Situations when a fund company is required to have both a custodian and a prime broker

Mutual fund companies would traditionally have a fund's portfolio assets held by a custodian, however, when launching liquid alternative funds, as permitted under the new NI 81-102 regulations, fund strategies that seek leverage or borrows for short positions would need to involve a prime broker.



To support this fund strategy, the custodian and prime broker would need to work together to make sure that assets and data are transferred seamlessly and accurately, in keeping with industry compliance standards.

One way to accomplish this is by entering into a tri-party agreement, whereby long assets are held by the custodian and a separate custody account is created for assets pledged as collateral. Essentially, the fund would have two custody accounts, one of which is controlled by the prime broker, also known as the “collateral account.” The prime broker’s authorization would be required prior to any assets being transferred out of the collateral account. Fund companies could find a tri-party arrangement to be beneficial.

Moving ahead

With this regulatory change, we expect that even greater coordination will be needed between prime brokers and custodians. With the resulting increase of middle office tasks, firms may choose to build upon their middle office capabilities or consider outsourcing operational and middle office services to a provider.

Beyond outsourcing, clients may want to look into enhancing their internal systems, from improved portfolio management systems to straight-through-processing and trade order management systems, in order to improve interfaces with service providers.

Leveraging the strength and capabilities of CIBC Mellon’s parent companies, CIBC and BNY Mellon, CIBC Mellon offers a liquid alternatives service model that provides prime custody administration, in addition to custody, fund accounting, recordkeeping and securities lending. CIBC Mellon can act as a single point of contact, greatly improving efficiencies in our clients’ management of their prime broker.

We are excited for the possibilities that this new regulatory framework may bring to the Canadian market and we look forward to continuing to provide our robust asset servicing solutions to Canadian institutional investors.

Allocation to Alternative Mutual Funds



By: **Jason Mann**
 CIO and Co-Founder,
 EdgeHill Partners

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It may well prove true that the timing has never been better for the introduction of “liquid alts.” The stark reality is that the traditional 60/40 model of stocks and bonds is broken in an environment of low interest rates. Bonds have typically been relied upon to provide a steady rate of return with low or negative correlation to equities. But with rates as low as they are, the forward rate of return on bonds simply can’t deliver the same results they did in the past. Increasing the weight of equities in one’s portfolio isn’t the solution, as equities will continue to have meaningful drawdowns that are unacceptable to an aging population. Advisors and their clients need an alternative, and liquid alts fit the bill. Simply put, the new 81-102 alternative mutual fund rules allow the average investor to access risk-managed solutions at a time when these strategies are most needed.

So, what are liquid alts an alternative to? We view them as alternative to bond allocations in that they can provide an uncorrelated return stream, similar to what bonds used to be able to provide, or as an alternative to long-only equities in that they can provide a cushion against major market drawdowns. When properly managed, liquid alts reduce portfolio volatility and downside, and improve investment outcomes, regardless of market direction.

At EHP Funds, we are the first manager to offer a family of liquid alternative mutual funds in Canada, utilizing the exemptive-relief process to allow us to use the proposed rules in advance of final publishing. We have successfully run long/short alternative strategies for more than five years in private funds offered under Offering Memorandum (OM), and are fortunate that these same strategies fit well into the new liquid alt structures.

We offer a range of funds, from defensive, low-volatility funds intended to replace a bond allocation, to “all-weather” long/short funds intended to replace an equity allocation.

Our core view is that this is a watershed moment for alternative managers in Canada. We feel that where a product has the attributes that would allow it to be offered under the new framework, the market will ultimately demand that a prospectus version is available, particularly for retail distribution. The new framework eliminates many of the prior objections to alternative fund adoption: no onerous documentation, transparency in a regulated environment, daily liquidity, and the ability to utilize the funds for all clients, not just the very wealthy.



For managers contemplating launching funds under the new rules, there are key considerations. Is the strategy itself suited for the framework? Is the underlying strategy truly liquid enough to offer daily liquidity, and could it handle large redemptions in a short time frame? Is the strategy scalable so that advisors can allocate to it over the long run? Is shorting and leverage being used to reduce risk, not enhance it? Does the manager have the risk management and compliance infrastructure to properly operate in a regulated environment?

Distribution and support of the product will be critical considerations as well. In the OM environment, we estimate there are fewer than 300 retail advisors who truly utilize alternative as a part of their portfolio construction. In the new liquid alt regime, there are likely to be thousands of advisors in the addressable market. Reaching and servicing them effectively is no small challenge for the typically smaller managers that offer OM funds today. Emerging managers may find that partnering with larger firms with distribution capacity or seeking sub-advisor relationships may better meet their objectives than building out an independent sales staff.

There are other challenges to the new liquid alt regime. As regulated mutual funds, these funds are more expensive to launch, and operating in a daily liquidity environment requires a commitment to back office capabilities, perhaps limiting them to more established managers. Gaining access to dealers' shelves will take time, and there are likely to be inconsistent and evolving risk-rating methodologies, limiting adoption rates for unproven strategies without existing track record.

Education will be a key factor in the adoption of these new funds. Already, progressive bank-owned and independent dealers are educating their advisors on the benefits of well-run liquid alts, and we expect that efforts will increase over time as more product becomes available. But for many years to come, a key part of the fund manager's role will be to act as trusted, knowledgeable educators on the benefits and pitfalls of risk-managed funds.

The new liquid alt rules are in many ways the birth of a new asset class in Canada. There will undoubtedly be stumbles along the way, but our hope is that managers and investors alike utilize the framework to do what it does best: provide better risk-adjusted returns to clients, and an alternative to traditional asset classes that may struggle to do so.

Operational Considerations for Alternative Mutual Funds



By: **Dennis MacPherson**
Senior Vice President,
SGGG Fund Services Inc.



When the concept of Liquid Alts was first introduced by the Regulators, there was some speculation that this would lead to opportunities for traditional fund managers to act as the sub-advisor on new Liquid Alt funds launched by large mutual fund complexes. To date, this opportunity has failed to materialize. Some may argue these mutual fund companies have a deep bench of talented portfolio managers able to develop alternative strategies in-house. Others may say that talent or not, they are unwilling to come out and say they need help. Or, perhaps the idea of co-branding was simply never in the cards.

It is interesting to note that the strategies permitted under Liquid Alts are viewed by mutual fund companies as a new way to be more alternative, while a traditional alternative manager views them as still pretty much “just a mutual fund”, albeit in the newest of un-ending flashy new wrappers.

A great many if not the majority of traditional alternative managers may find the new rules still too restrictive to do what they do best. Whether it relates to leverage limits or restrictions on private investments, the core strategy of many existing alternative funds simply will not fit within the new framework. In other words, a traditional manager contemplating the launch of a Liquid Alt fund may find that it in fact requires a brand new strategy, one more subdued than they may be used to.

Selling the Funds

Traditional alternative managers should have a solid understanding of why they might launch a Liquid Alt fund, what is involved, and how it is different from what they are used to. ‘Because everyone else is doing it’ may or may not be a factor, but should not be the sole deciding factor.

For example, as a manager you may be at first excited about having a low minimum initial purchase amount. You need to consider what the costs are to carry this account, and set a realistic minimum accordingly. At the same time, you need to be careful about having a ‘hard edit’ that rejects purchases below the minimum; it is always the rep with \$10M AUM placing a \$1,000 buy for their child’s RESP that gets the reject and now you have to spend time to calm them down and repair the relationship.



A better approach may be to let all purchases in, then review account balances periodically and redeem the small accounts you want to after looking at the big picture.

This brings up another point: the reps that want to give you small purchases may not be the same UHNW discretionary reps you have worked hard to foster relationships with. Many alt managers have raised hundreds of millions of AUM through a hand-full of advisors at a select few IIROC firms, all fee-based and no one ever asked about commissions and trailer fees. Understand that the sales effort to raise the same level of AUM \$5,000 at a time takes a lot longer, is a lot more work, and requires a lot more relationships. Have you installed that top of the line CRM software yet? You will need it! Smaller tickets mean a higher volume of everything that goes with it.

Operational Considerations

So you decided to go ahead and launch a Liquid Alt. The excitement may last as long as the first call to your back office administrator. Admin firms operating in Canada are typically good at either handling daily NAV funds, or working with alternative products, but not both. Striking daily NAVs quickly and accurately is no simple task. Timelines are compressed; NAVs need to be reported out to the media by 6pmET and there is definitely no time to review and sign off on every NAV package.

As you would expect, it costs more to value a fund 20 times per month versus once; you should expect the NAV fee to be about double what it would be for a similar fund valued monthly. The good news is all other services are not impacted by daily NAVs, so those fees should be substantially similar. This includes things like financial statements, distribution calculations, dealing with auditors, etc.

One important difference is an 81-102 fund is required to prepare an “MRFP” or Management Reports of Fund Performance. This is a disclosure type document made available to investors and includes things like Top-20 Holdings, Asset Mix, etc. It is routine stuff for an administrator experienced in 81-102 funds but needs to be completed either way.

You will also need to create a Fund Fact Sheet using the regulator prescribed format. Important aspects of this are data elements such as “Classification” and “Risk Rating”. These points will also be important to the internal risk ratings assigned by various dealer firms when adding the funds to their shelf for advisors. You should assume most all of them will default to a ‘high’ rating at least for the immediate short term.

The good news is (presumably) since there are no subscription agreements, the annual 45-106F1 Report of Exempt Distribution should not be required. Matching sub docs to purchases and recording the exemption codes for each investor will surely be missed by all.

Looking Ahead

The Liquid Alts regime represents a huge opportunity for the investment fund industry. Managers should tame initial excitement and give careful consideration to how these funds fit into their long-term business plan. This does not mean ‘wait and see’; it means have a plan. What you can be sure of is that ‘Alternatives’ will become an increasingly mainstream term, but not necessarily less mysterious to investors, so be prepared to have the conversations. And you can be just as sure that the next wave of demand for alternatives from dealers, advisors and investors is only as far away as the next major equities correction.

Opportunities for Traditional Alternative Managers



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In this exciting new market environment, there are a number of regulatory and compliance considerations you should be aware of as you prepare to launch an alternative mutual fund. As with the introduction of any new product, there will most likely be increased scrutiny by regulators on your public documents to ensure all requirements are adhered to. As such it is increasingly important to ensure you have the necessary resources to be able to work with regulators through their reviews.

Offering Documents

In order to offer units to the public, an alternative mutual fund will be required to prepare a simplified prospectus, an annual information form (AIF), and a Fund Facts document for every class or series of the alternative mutual fund. In addition to the disclosure requirements under NI 81-101, Mutual Fund Prospectus Disclosure for a traditional mutual fund, an alternative mutual fund is required to disclose that it is an alternative mutual fund on the front cover of these documents as well as describe the features of the mutual fund that cause it to fall within the definition of alternative mutual fund, highlighting all details surrounding the potential sources and uses of leverage.

An alternative mutual fund may distribute its securities under a simplified prospectus for 1 year, after which, a renewal must be obtained. As part of this renewal, an alternative mutual fund must also file the written consent of

certain professionals, including auditors, if that company is named in a document incorporated by reference as a result of having opined on financial statements from which selected information is included in the simplified prospectus.

Financial Statements

Annual audited financial statements are required to be filed with regulators 90 days after year end. The Independent Auditors' Report included in the financial statements will include a two-year audit opinion as well as note specifically other information that was prepared by management and the auditor's consideration as to whether the information is materially inconsistent with the financial statements. This other information may include the Management Report of Fund Performance, AIF and Fund Facts. In addition, semi-annual financial statements are required to be filed 60 days after the period end.



NI 81-106, Investment Fund Continuous Disclosure, also requires an alternative mutual fund to disclose, in its financial statements, a brief explanation of the sources of leverage (including cash borrowing, short selling or the use of specified derivatives) as well as the lowest and highest level of the aggregate exposure to those sources during the year and an explanation of the significance to the alternative mutual fund for holding such exposure.

Additional Supplemental Documents

Annual and interim Management Reports of Fund Performance will need to be written and attached to the financial statements. This report, prepared by management, is required to include a discussion of fund performance and results of operations, financial highlights, key ratios, past year by year performance, and a summary of the top holdings in the fund's investment portfolio.

This report, as mandated in NI 81-106F1, Contents of Annual and Interim Management Report of Fund Performance has prescriptive headings, subheadings and language that must be included when writing this report.

Compliance Reporting

NI 81-102, Investment Funds, Part 12 requires that a mutual fund or its principal distributor must complete and file a report describing compliance by the mutual fund during that financial year with the applicable requirements of Parts 9, 10 and 11 within 140 days of year end. Compliance will require that there is timely transmission and receipt of purchase/redemptions orders, ensuring the issue/sale price of the unit is equal to the NAV per unit on the transaction date and that there is timely receipt/payment of cash or wire transfers. Furthermore, trust accounts must be properly maintained with only permissible activities allowed surrounding subscriptions, redemptions and expenses of the alternative mutual fund to ensure that there is no commingling of cash with the financing or operations of a person or company providing services to the alternative mutual fund.

A corresponding report by the auditor of the alternative mutual fund over the compliance report must also be obtained within the same time frame.

National Considerations

For alternative mutual funds that distribute in Québec, key documents must also be translated into French.

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