NI 81-102 Alternative Mutual Fund Overview & Market Impact Survey Results

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Timing of Enforcement of New Rule

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Effective Date

January 3, 2019

Transition

July 4, 2019

for existing commodity pools to give them time to update their operational framework

Alternative Strategies

- Alternative strategies used to be available through privately offered funds only – typically using an offering memorandum to sell securities and are tailored to “accredited investors” and other exempt purchasers or through commodity pools
- Now **Alternative Mutual Funds** have the ability to distribute their securities on a continuous basis to retail investors under a simplified prospectus
- These changes have created significant opportunities for hedge fund managers and will allow alternative asset managers to market and grow their assets under management through a new distribution channel
- This new market is estimated to potentially be **over $100B**

Commodity Pools and Non-redeemable Investment Funds

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- Commodity pools and non-redeemable investment funds previously offered to the public under NI 81-104 will now be classified as alternative mutual funds and NI 81-104 will be renamed “Alternative Mutual Funds”.

- The new rules also modify certain investment restrictions for non-redeemable investment funds (closed-end funds) that were considered to be inter-related with the alternative mutual funds framework.

What Is An Alternative Mutual Fund?

- An “alternative mutual fund” means 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.
- Definition is intentionally broad and it is intended to capture as many types of alternative investment strategies and alternative asset classes as possible
- Commonly referred to as ‘liquid alts’

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

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Definition. An "alternative mutual fund" is defined as a mutual fund, other than a precious metals fund, that has adopted fundamental investment objectives that permit it to invest in physical commodities or specified derivatives, to borrow cash or engage in short selling in a manner not permitted for other mutual funds.

Concentration. Investments in any one issuer can be no more than 20% of net asset value (NAV) (in comparison to 10% for conventional mutual funds). This does not apply to "government securities."

Physical commodities. Alternative mutual funds are exempt from any restrictions relating to the investment in physical commodities.

Collateral. 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

Illiquid assets. Illiquid assets are limited to 10% of NAV after purchase or 15% of NAV at any time. This same rule currently applies to conventional mutual funds.

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Borrowing. Alternative mutual funds can borrow up to an amount equal to 50% of their NAV. They can only borrow from entities that qualify as an investment fund custodian or sub-custodian under sections 6.2 or 6.3 of NI 81-102, which essentially restricts borrowing to Canadian and foreign banks and trust companies (or their qualified dealer affiliates).

Short selling. Alternative mutual funds can short sell securities up to an amount equal to 50% of their NAV (in comparison to 20% for conventional mutual funds). In addition, in order to facilitate long/short strategies, alternative mutual funds will not be required to maintain cash cover for their short positions.

Combined limit on borrowing and short selling. The aggregate of all cash borrowing and exposure under short selling for alternative mutual funds is limited to 50% of NAV.

Counterparty requirements. Unlike conventional mutual funds which are required to deal with counterparties that have a "designated rating" (generally, a rating of "A" or higher for the counterparty's long-term debt), alternative mutual funds are exempt from this requirement, enabling them to enter into over-the-counter (OTC) derivatives transactions with a wider variety of counterparties (i.e. counterparties that do not have a designated rating).

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Exposure limit for derivative counterparties. Alternative mutual funds can use specified derivatives to create synthetic leveraged exposure, although they must limit their mark-to-market exposure with any one counterparty to 10%, unless such counterparty has a designated rating in which case the limitation will not apply.

Total leverage. The aggregate gross exposure achievable by an alternative mutual fund through borrowing, short selling or the use of specified derivatives (excluding specified derivatives used for hedging purposes) cannot exceed three times its NAV. The total leverage limit includes exposure gained by the alternative mutual fund from investments in underlying alternative mutual funds that employ leverage. The leverage limit of three times NAV is a departure from the current commodity pool rules, which have no limit on notional exposure.

Fund-of-fund investing. Conventional mutual funds will be able to invest up to 10% of their net assets in alternative mutual funds and non-redeemable funds that are subject to NI 81-102. This significantly increases the potential demand for alternative mutual funds, as mutual funds in Canada hold approximately $1.5 trillion in assets. Alternative funds will be able to invest up to 100% of their NAV in any other mutual funds or non-redeemable investment funds that are subject to NI 81-102.

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

An alternative mutual fund will be required to have a custodian. The requirements for entities to qualify to act as custodian or sub-custodian of an investment fund have been amended to remove the requirement that affiliates of domestic and foreign banks and trust companies to have publicly available financial statements reflecting the required amount of equity.

Redemption price. An alternative mutual fund may choose to determine its redemption price by reference to the NAV on the first or second business day after the receipt of a redemption order. This is in contrast to the rule for conventional mutual funds which mandates the NAV next determined after the receipt of a redemption order.

Redemption deferral. Provided that it is disclosed in the simplified prospectus of the alternative mutual fund, redemptions can be restricted for a period of up to six months after the receipt for the initial prospectus is issued.

Performance fees. Unlike conventional mutual funds, which can only charge performance fees tied to a reference benchmark or index, alternative mutual funds may charge performance fees based on the total return of the fund itself. However, performance fees are subject to a permanent high water mark.

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Proficiency and distribution. The proficiency requirements contained in NI 81-104 will be amended to apply to alternative mutual funds and NI 81-104 will be renamed *Alternative Mutual Funds*. Accordingly, mutual fund dealers will not be permitted to distribute securities of alternative investment funds unless they meet such proficiency requirements.

Offering documents. Alternative mutual funds can be distributed to retail investors under a simplified prospectus in the same manner as conventional mutual funds. Alternative mutual funds are required to prepare a simplified prospectus, annual information form and fund facts document.[1] There are specific disclosure requirements which need to be contained therein.

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

Fund facts document. The fund facts/ETF facts for alternative mutual funds must include specific text box disclosure which identifies the fund as an alternative mutual fund, how the alternative fund differs from conventional mutual funds, as well as additional disclosure regarding their lenders (if the alternative fund intends to borrow cash) and the use of leverage.

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Continuous disclosure. Alternative mutual funds are subject to the same ongoing disclosure requirements as other prospectus qualified investment funds and will be required to disclose actual use of leverage in their financial statements, similar to the current requirements for commodity pools. The requirements in NI 81-104 are being repealed and moving to NI 81-102.

Seed capital. Alternative mutual funds have a minimum seed capital requirement of $150,000, the same as all mutual funds. Managers of alternative mutual funds will be able to redeem this seed capital investment once the fund has raised at least $500,000 from investors. This is a departure from the current commodity pool rules, which require the manager to maintain a minimum of $50,000 in seed capital for the life of the commodity pool.

Fundamental changes. The current rules that apply to all investment funds regarding fundamental changes (events requiring unitholder approval) will also apply to alternative mutual funds.