

Canadian Securities Administrators propose a regulatory framework for offering hedge funds to the public

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On September 22, 2016, the Canadian Securities Administrators (CSA) published *Notice and Request for Comment — Modernization of Investment Fund Product Regulation — Alternative Funds* (the Proposal). The Proposal introduces a framework for offering retail investors access to “alternative funds” (commonly known as hedge funds) through a series of amendments to *National Instrument 81-102 Investment Funds* (NI 81-102), which currently governs all publicly offered mutual funds and non-redeemable investment funds in Canada. The Proposal would permit hedge fund managers to offer alternative funds to the retail market through a long-form prospectus offering.

The Proposal, while focused on alternative funds, also includes provisions that will impact other types of mutual funds (namely conventional mutual funds and exchange-traded funds), as well as non-redeemable investment funds, through changes to the investment restrictions in NI 81-102 relating to investments in physical commodities, other investment funds and illiquid assets. Under the Proposal, *National Instrument 81-104 – Commodity Pools* (NI 81-104) — which governs commodity funds like gold or precious metal funds — would be repealed as these types of funds would now be governed by NI 81-102. The Proposal provides a six-month transition period for existing investment funds to comply with the changes.

What are alternative funds?

Alternative funds (ALTs) use strategies that are not generally permissible for mutual funds, such as short-selling, borrowing, investing in illiquid assets and taking concentrated positions in a small number of issuers. As a result, ALTs do not typically provide daily liquidity. Rather, investments are often subject to an initial lock-up period (one to two years is common), and after that, ALTs may offer monthly or quarterly redemptions, in some cases subject to a “gate” (which is a limitation expressed as a percentage of the investment which may be redeemed as of each redemption date).

Because of their complex strategies and limited liquidity, ALTs have historically been considered too risky for retail investors, in contrast to traditional, “safe” mutual funds, which maintain generally diverse, long-only portfolios of publicly traded securities and provide daily liquidity. ALTs have been the domain of sophisticated institutional investors which could bear the loss of their entire investment, and did not need immediate access to invested funds. This attitude began to change following the 2008 financial crisis, as investment professionals and securities regulators have become increasingly aware that ALTs can play an important risk management role in all investment portfolios by providing exposure to non-traditional asset classes and using hedging strategies which seek to be uncorrelated to equity market returns.

Alternative funds proposal

The CSA first proposed a framework for the regulation of alternative funds in March 2013 as part of Phase 2 of the Investment Funds Modernization Project, as a broadening of the scope of NI 81-104. In this initial proposal, the CSA sought feedback regarding naming conventions, proficiency standards for dealing representatives and appropriate investment restrictions, as well as strategies and asset classes which should apply to publicly-offered ALTs. The initial proposal was very novel and ultimately the CSA deferred its consideration of ALTs until the second stage of Phase II of the Investment Funds Modernization initiative.

After publishing a brief update in February 2015, which described the results of the alternative funds consultation process, the Proposal was recently published for a 90-day comment period ending December 22, 2016. The Proposal seeks to balance the objectives of providing retail investors with access to the growing and dynamic alternative asset class, while still maintaining certain safeguards aimed at protecting investors.

Fund managers will continue to be able to offer hedge funds in the exempt market on the same terms and conditions as they always have. However, managers that seek to publicly sell hedge funds to retail investors must comply with the rules applicable to ALTs as outlined in the Proposal.

Investment restrictions applicable to ALTs

The Proposal provides some latitude for alternative funds to engage in the investment strategies which they currently use in the exempt market. The following table sets out the proposed differences in the key investment restrictions applicable to mutual funds and ALTs:

	Mutual Funds	ALTs
Concentration restriction	No more than 10% of net asset value (NAV) invested in securities of any one issuer	No more than 20% of NAV invested in securities of any one issuer
Investments in illiquid assets	No more than 10% of NAV at time of purchase No more than 15% of NAV for 90 days or more	No more than 10%* of NAV at time of purchase No more than 15%* of NAV for 90 days or more
Borrowing	5% of NAV at time of borrowing, for limited purposes	50% of NAV for all purposes including portfolio investments
Short selling	No more than 5% of NAV in one issuer No more than 20% of NAV total shorts	No more than 10% of NAV in one issuer No more than 50% of NAV total shorts

* The CSA is considering whether to permit ALTs to invest a greater percentage of NAV in illiquid assets, understanding that this will impact the frequency of redemptions.

The Proposal suggests aggregate leverage metrics for alternative funds, while seeking further input regarding how leverage should be calculated. For example, the Proposal establishes a cap for ALTs on aggregate short selling and cash borrowing of 50% of NAV at any time, and a cap on aggregate gross exposure through borrowing, short selling and the use of specified derivatives, of three times NAV, including hedging transactions. The CSA solicits comment on whether offsetting or hedging transactions should be permitted to reduce calculated leverage, and whether there are better ways to calculate leverage which more accurately reflect a fund's risk exposure.

The Proposal does not set any limits for ALTs to trade in “cleared specified derivatives” registered with a regulated clearing agency in Canada, the United States, or Europe. Further, there are no restrictions on the type of counterparty with which an alternative fund may trade in over-the-counter derivatives, provided that marked-to market exposure to any one counterparty is capped at 10% of NAV.

The Proposal subjects ALTs to the same restrictions on fund-on-fund investing that apply to mutual funds, including that the underlying fund(s) must comply with NI 81-102 and be a reporting issuer in the jurisdiction. These restrictions would preclude alternative funds from investing in foreign or private hedge funds, including through a “master-feeder” structure which is common in global hedge fund complexes that seek to provide exposure to best-in-class international managers at the master fund level while at the same time addressing with local tax and regulatory considerations at the feeder fund level.

Investor protections

While the Proposal offers ALTs the freedom to pursue non-traditional investment strategies, it imposes the same core investor protection requirements that apply to all publicly offered investment funds. Alternative funds will be required to file a prospectus and publish the Fund Facts point-of-sale document in the prescribed form. These disclosure standards are higher than the unregulated offering memoranda and investor presentations under which hedge funds are offered in the exempt market. While many Canadian-domiciled private hedge funds already comply with requirements to prepare audited annual financial statements and unaudited semi-annual financial statements, ALTs will need to make these statements publicly available, including Statements of Investment Portfolio, which provide position level transparency.

In addition, ALTs will need to provide security-holder approval rights for certain fundamental changes and comply with the related meeting and disclosure requirements, as well as the restrictions on sales communications and prohibited representations which apply to mutual funds. Although these investor protections will impose incremental regulatory obligations on hedge fund managers, we believe that many Canadian managers will have the compliance resources to address these requirements because they are already subject to the adviser and investment fund manager registration regime.

Relationship with current and proposed suitability obligations

The Proposal seeks comment regarding what types of enhanced proficiency requirements ought to apply to dealing representatives that sell alternative funds. The CSA states that it is working with the Mutual Fund Dealers Association (MFDA) on this issue, but it does not purport to interfere with the current requirements applicable to dealing representatives that sell hedge funds on the platform of the Investment Industry Regulatory Organization of Canada (IIROC).

Even with additional education and training, it will still be difficult for dealers to develop and apply a uniform set of know-your-client (KYC) and know-your-product (KYP) criteria when determining the suitability of an alternative fund for a client’s portfolio. ALT strategies are complex and have traditionally been perceived as more risky, however, the industry now recognizes that alternative fund investments can be used to mitigate portfolio risk. Given this unique risk profile, the basic risk tolerance scale included on most KYC forms is unlikely to be adequate. In addition, although ALTs are being lumped together as an asset class for the purposes of the Proposal, their investment objectives, strategies and underlying investment portfolios are very diverse. It may therefore be too simplistic in some cases to allocate a proportion of a client’s asset mix to “alternatives,” and preferable to sub-allocate to ALTs

within each asset class where appropriate. Ongoing consideration of macro market factors as well as individual client circumstances will be necessary when determining the suitability of an alternative fund or strategy.

When seeking to address the KYC, KYP and suitability challenges posed by alternative funds, IIROC and MFDA members will likely be cognizant of the proposed targeted reforms to these requirements set out in *CSA Consultation Paper 33-404: Proposals to Enhance the Obligations of Advisers, Dealers and Representatives Toward their Clients*. The consultation paper introduces new guidelines for dealers when constructing their approved product lists which are designed to give investors access to a range of suitable investments, including by conducting a fair and unbiased market investigation, product comparison and product optimization analysis based on client needs and objectives. Faced with these new requirements relating to their existing product line-ups, the Proposal may not necessarily result in broad exposure to the retail public of the new ALT asset class.