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CSA finalizes alternative mutual funds regime

On October 4, 2018, the Canadian Securities Administrators (the CSA) published amendments (the Amendments) to National Instrument 81-102 *Investments Funds* (NI 81-102) and National Instrument 81-104 *Commodity Pools* (NI 81-104) to establish the new “alternative mutual funds” regime. Subject to Ministerial approval, the Amendments will come into force on January 3, 2019.

Canadian public investment funds, including conventional mutual funds, exchange-traded funds (ETFs) and non-redeemable funds (i.e., closed-ended funds) are subject to investment restrictions and limitations under NI 81-102. Historically, exceptions to these restrictions were provided for commodity pools, which were specialized mutual funds permitted to invest in derivatives and physical commodities under former NI 81-104 in a manner not permitted for other Canadian public investment funds. The alternative mutual funds regime modernizes the commodity pool regime by expanding the scope of alternative strategies in which such funds may invest, including various leverage strategies described in the chart below. Existing commodity pools will automatically become alternative mutual funds when the Amendments come into force but will have until July 4, 2019 to comply with the new rules applicable to alternative mutual funds.

Since May 2018, the CSA has approved a few families of alternative mutual funds which launched ahead of the publication of the Amendments pursuant to discretionary exemptive relief.

The Amendments are part of the final phase of the CSA’s investment fund modernization project, published in draft in September 2016 and described in our Update [“CSA proposes a regulatory framework for offering hedge funds to the public.”](#)

Investment restrictions and limitations

The chart below summarizes the primary differences between investment restrictions and limitations under NI 81-102 that will be applicable to conventional mutual funds and ETFs, alternative mutual funds and non-redeemable investment funds when the Amendments come into force.

Investment restrictions and limitations	Conventional mutual funds / ETFs	Alternative mutual funds	Non-redeemable investment funds
Cash borrowing	May borrow cash in an amount up to a maximum 5% of the fund's net asset value (NAV), generally only as a temporary measure to accommodate redemptions or to settle portfolio transactions, provided that the lender is a qualified custodian	May borrow cash for investment purposes in an amount up to a maximum of 50% of the fund's NAV, provided that the lender is a qualified custodian or sub-custodian, including a foreign sub-custodian	Same as alternative mutual funds
Short selling	May sell securities short having a maximum value equal to 20% of fund's NAV in the aggregate, with single issuer limited to 5% of fund's NAV	May sell securities short having a maximum value equal to 50% of fund's NAV in the aggregate, with single issuer limited to 10% of fund's NAV	Same as alternative mutual funds
Cash cover for short sales	150% cash cover required. Can't use cash from short sale to enter into long position in a security, other than a cash cover security	No cash cover required	Same as alternative mutual funds
Combined cash borrowing and short sale limit	Total cash borrowed and market value of securities sold short cannot exceed 50% of fund's NAV (however, in the case of conventional mutual funds, reaching this limit would not be possible)	Same as conventional mutual funds	Same as conventional mutual funds
OTC and exchange traded derivatives	Designated rating requirements for uncleared options, debt-like securities, swaps and forward contracts (for instrument or counterparty)	Designating rating requirements do not apply	Same as alternative mutual funds
	Counterparty exposure limit of 10% of fund's NAV based on mark-to-market value of exposure under uncleared derivatives position, unless the counterparty (or its guarantor) meets certain designated rating requirements	Same as conventional mutual funds	Same as conventional mutual funds
	Investments in options (or debt-like securities with an options component) for non-hedging purposes limited to 10% of fund's NAV. Full coverage obligations in respect of options, forwards, futures and swaps if used for non-hedging purposes	Coverage obligations for specified derivatives used for non-hedging purposes will not apply	Same as alternative mutual funds

Investment restrictions and limitations	Conventional mutual funds / ETFs	Alternative mutual funds	Non-redeemable investment funds
Total leverage limit	Leverage is implicitly restricted due to limited ability to borrow and ability to enter in uncovered derivatives	Gross exposure being sum of cash borrowings, market value of securities sold short and notional value of specified derivative positions (other than positions used for hedging purposes) cannot exceed 300% fund's NAV	Same as alternative mutual funds
Concentration restriction	Maximum 10% of the fund's NAV in any one security with limited exceptions	Maximum 20% the fund's NAV in any one security with limited exceptions	Same as alternative mutual funds
Control restriction	Maximum 10% of the (a) votes attaching to the outstanding voting securities of the issuer, or (b) the outstanding equity securities of the issuer, with limited carve-outs including for investment fund securities and index participation units. Cannot invest in securities of an issuer for the purpose of exercising control over, or management of, the issuer	Same as conventional mutual funds	Same as conventional mutual funds
Prohibited investments types	<ul style="list-style-type: none"> • Real property • Mortgages other than guaranteed mortgages • Maximum 10% of fund's NAV in guaranteed mortgages • Precious metal certificates (other than gold, silver, platinum or palladium) • Physical commodities (other than up to 10% in gold, silver platinum or palladium, permitted gold, silver platinum or palladium certificates, or derivatives which have a physical commodity or precious metal certificate underlier) • Loan syndication or loan participation interests if the fund would be required to assume administration of loan in relation to borrower 	Same as conventional mutual funds, but unrestricted in respect of precious metal certificates and physical commodities	Same as alternative mutual funds
Illiquid assets	Maximum 10% of fund's NAV in illiquid assets (with hard cap of 15% for up to 90 days)	Same as conventional mutual funds	Maximum 20% of fund's NAV in illiquid assets (with hard cap of 25% for up to 90 days)

Investment restrictions and limitations	Conventional mutual funds / ETFs	Alternative mutual funds	Non-redeemable investment funds
Investments in other investment funds	Up to 100% of fund's NAV in underlying conventional mutual funds and ETFs subject to NI 81-102 (unless index participation unit which may not be subject to NI 81-102)	Up to 100% of fund's NAV in underlying conventional mutual funds and ETFs subject to NI 81-102 (unless index participation unit which may not be subject to NI 81-102)	Same as alternative mutual funds
	Up to 10% of fund's NAV in underlying public alternative funds and non-redeemable investment funds subject to NI 81-102 (unless index participation unit which may not be subject to NI 81-102)	Up to 100% of fund's NAV in underlying alternative mutual funds and non-redeemable investments funds subject to NI 81-102 (unless index participation unit which may not be subject to NI 81-102), or in underlying funds that comply with the provisions of NI 81-102 that are applicable to alternative mutual funds or non-redeemable investment funds and that are reporting issuers in Canada (unless index participation unit)	Same as alternative mutual funds
	Underlying fund cannot invest more than 10% of its NAV in other investment funds (except if it's a clone fund, or otherwise invests in money market funds or index participation units)	Same as conventional mutual funds	Same as conventional mutual funds
Restrictions on granting of security interests	Cannot provide security interest over portfolio assets, except in connection with acceptable cash borrowings, permitted derivative and short sale transactions, or for securing fees and expenses of custodians and sub-custodians	Same as conventional mutual funds	Same as conventional mutual funds
Securities lending, repurchase transactions and reverse repurchase transactions	Permitted, subject to certain requirements	Same as conventional mutual funds	Same as conventional mutual funds.

Proficiency standards for mutual fund dealing representatives

Like their predecessor commodity pools, alternative mutual funds may only be sold by mutual fund dealing representatives who meet enhanced proficiency requirements, including a passing grade in the Canadian Securities Course or Derivatives Fundamentals Course, or completion of the Chartered Financial Analyst program. The CSA had indicated in the draft Amendments that new proficiency requirements might apply under the alternative funds regime, however, these changes have been deferred and will be addressed in the CSA's ongoing work on more holistic changes to dealer proficiency standards. Once this work is complete, the CSA expects to repeal NI 81-104, as the only provisions left in the old commodity pools rule are the proficiency requirements.

Incentive fees

Alternative mutual funds are permitted to charge incentive fees based on the performance of the fund, provided that the fee is based on the cumulative total return of the fund for the relevant performance period and the calculation methodology for the fee is disclosed in the prospectus of the fund. No other public investment funds are permitted to charge performance-based compensation. The ability to charge incentive fees reflects the typical compensation structure of private alternative funds (commonly known as "hedge funds") and is consistent with the former commodity pool regime.

Risk rating

In its consultation on the draft Amendments, the CSA solicited comment on whether the investment risk classification methodology, which applies to other public investment funds and is based on the fund's standard deviation from a reference index, would be appropriate for alternative mutual funds. Although numerous suggestions for alternative risk rating frameworks were proposed by alternative investment managers, the CSA decided to maintain a uniform methodology for all public mutual funds in order to foster greater comparability of risk ratings. The Amendments provide additional guidance for funds to consider when they employ an investment strategy which result in atypical distribution of performance results, encouraging such funds to use "upside discretion" for their risk ratings.

Changes to the custodian regime

Part 6 of NI 81-102 contains a rigorous custodial regime for Canadian public investment funds. As part of implementation of the alternative mutual funds regime, NI 81-102 will be expanded to permit: (a) margin to be posted for transactions inside and outside of Canada involving cleared specified derivatives with eligible dealers and clearing corporation members provided the amount of margin with any one dealer or clearing corporation member does not exceed 10% of the fund's NAV; (b) fund assets over which a security has been granted may be deposited with an eligible lender of cash to the fund; and (c) for alternative mutual funds and non-redeemable investment funds, to permit the deposit of fund assets with non-custodian borrowing agents (in connection with short sales) provided such assets do not exceed 25% of the fund's NAV at the time of deposit. The existing custodial exceptions for margin in respect of clearing corporation options, options on futures and standardized futures, assets deposited with OTC derivatives counterparties, and assets delivered in connection with securities lending, repurchase transactions and reverse repurchase transactions largely remain unchanged.

The Amendments also remove the requirement for certain sub-custodians to have their audited financial statements made public to be qualified to act as a custodian or sub-custodian, primarily to allow bank-owned dealers with consolidated financial statements to provide services to alternative mutual funds.