Phase 2 Of The Modernization Of Investment Funds Project – Alternative Funds Framework And Extension Of Comment Period

CSA propose to redesign the regulatory framework for "alternative funds"

*This is the fifth in a series of McMillan bulletins relating to the Canadian Securities Administrators (CSA) project to modernize the regulation of publicly offered investment funds. The bulletins separately address how the modernization project affects various types of investment fund products. Previous bulletins focused on changes affecting open-end mutual funds and non-redeemable investment funds (**closed-end funds or CEFs**). This bulletin looks at the proposed regulatory framework for investment funds that focus on alternative asset classes or alternative investment strategies (**Alternative Funds**).*

On March 27, 2013 the CSA published proposed changes to the regulatory regime governing investment funds pursuant to Phase 2 of its Modernization of Investment Fund Product Regulation Project (the **Modernization Project**). The original comment period was scheduled to close on June 25, 2013. However, the CSA have recently extended the comment period until August 23, 2013.

In this installment of our series on the Modernization Project, we summarize and discuss the proposed changes to National

Instrument 81-104 *Commodity Pools* (**NI 81-104**), which would create a regulatory framework for Alternative Funds (including mutual funds and CEFs). The CSA did not publish specific amendments to NI 81-104 in their request for comments; rather, the CSA asked for feedback on the key elements of a proposed regulatory framework that would inform future rule-making. Specific proposed amendments to NI 81-104 have yet to be published and the potential redesign of NI 81-104 remains highly conceptual at this stage.

In the notice extending the comment period, the CSA stated that the proposals related to NI 81-104 will require more time to consider and evaluate in conjunction with certain investment restrictions proposed for CEFs. Accordingly, the CSA have specifically not invited feedback on proposed investment restrictions relating to investments in physical commodities, borrowing cash, short selling and the use of derivatives (which will presumably be addressed together with any future amendments proposed to NI 81-104).

background to alternative funds framework proposal

NI 81-104 currently applies to commodity pools that invest in specified derivatives or physical commodities in a manner not permitted under National Instrument 81-102 *Mutual Funds* **(NI 81-102**). Commodity pools are mutual funds which are generally governed by NI 81-102, but they are exempt, by virtue of NI 81-104, from certain requirements contained in NI 81-102.

The CSA are proposing to expand the regulatory framework of NI 81-104 beyond specified derivatives and commodities to apply more generally to all investment funds (including mutual funds and CEFs) that invest in a manner that would not be permitted under NI 81-102. The CSA are seeking feedback on what exemptions from NI 81-102 are appropriate for Alternative Funds, as well as whether additional disclosure requirements and proficiency requirements for the sale of Alternative Fund securities are needed. The CSA have also expressed a desire to help investors differentiate between Alternative Funds and conventional mutual funds.

The CSA stated that certain exemptions from NI 81-102 that apply to commodity pools under NI 81-104 would continue to apply to Alternative Funds, including the ability to create leverage using specified derivatives as well as invest in physical commodities directly and indirectly.

"alternative fund" to replace "commodity pool"

Under the CSA proposal, Alternative Funds would be permitted to invest in asset classes and use strategies not permitted by NI 81-102 by virtue of exemptions contained in NI 81-104. To reflect the broader application of NI 81-104 to Alternative Funds, the CSA propose to replace the term "commodity pool" with "alternative fund". The CSA propose to define "alternative fund" as an investment fund that states it is an Alternative Fund in its prospectus.

The CSA have sought feedback on whether the term "alternative fund" properly describes the types of funds that should be captured by the proposed amendments to NI 81-104 and whether requiring Alternative Funds to include the words "alternative fund" in their name would aid investors to more easily differentiate them from other types of investment funds. For the same reason, the CSA are considering whether it would be beneficial for investment funds that are only governed by NI 81-102 to include words such as "conventional fund" in their name.

limits on borrowing and leverage

As mutual funds subject to NI 81-102, commodity pools are currently prohibited from borrowing cash except for specified purposes. As part of the changes proposed under Phase 2, CEFs would become subject to NI 81-102 and would have to limit their cash borrowing to 30% of the net asset value (**NAV**) of the Fund. The CSA are considering whether Alternative Funds should be permitted to exceed the cash borrowing limit proposed for CEFs, and in this regard are considering a limit of 50% of the NAV of the Fund. The CSA have also sought feedback on whether Alternative Funds structured as mutual funds should have a different borrowing limit than those structured as CEFs.

The CSA also propose to create a single cap of 3:1 on the total amount of leverage used by Alternative Funds, irrespective of whether leverage is created through cash borrowing, short selling, derivatives transactions or investing in an underlying fund that employs leverage. Given the need to fund regular redemptions, the CSA have sought feedback on whether Alternative Funds structured as mutual funds should have a lower total leverage cap.

The CSA have also sought feedback on the way in which leverage is measured and disclosed, and whether other measurement methods could be used to better inform investors about the amount and type of leverage employed by Alternative Funds. Currently, the maximum leverage used by an investment fund must be disclosed as a ratio of total long positions, including leveraged positions, plus total short positions divided by the net assets of the fund.

increased concentration restriction?

The CSA are considering whether Alternative Funds should be permitted to invest a larger percentage of their NAV in securities of a single issuer than the 10% restriction proposed under NI 81-102. The CSA have asked for feedback on what types of alternative investment strategies might require increased concentration restrictions and what an appropriate restriction should be. In addition, they have sought feedback on whether a different measure of concentration would be more appropriate for Alternative Funds given their ability to gain leveraged exposure (for example, whether the measure of concentration should be based on notional exposure of the portfolio).

restrictions on fund-of-fund structures

The CSA are also considering allowing Alternative Funds to invest in underlying investment funds (including other Alternative Funds) subject to certain conditions similar to those that apply to fund-of-fund investments under NI 81-102. An Alternative Fund would be permitted to invest in other investment funds provided that the underlying funds are reporting issuers in the same jurisdictions as the Alternative Fund (e.g., prohibiting investment in foreign funds or Canadian funds that are offered pursuant to a prospectus exemption). The CSA are not contemplating the inclusion of an exemption from these requirements in NI 81-104, and are of the view that the discretionary exemptive relief process is the appropriate avenue to address any proposed fund-of-fund structures that involve underlying investment funds that are not reporting issuers in the same jurisdictions as an Alternative Fund.

higher short selling limits

The CSA are proposing that Alternative Funds be permitted to sell securities short provided that they limit aggregate short sale exposure to 40% of the NAV of the fund, and short sale exposure to any single issuer to 10% of the NAV of the fund, calculated at the time of the short sale. This is consistent with exemptive relief that securities regulators have granted to commodity pools in the past. The CSA are also considering an exemption for Alternative Funds from the requirements to: (i) hold cash cover (e.g., cash, cash equivalents, money market instruments) in respect of securities sold short, and (ii) only use the short sale proceeds to purchase securities that qualify as cash cover.

no more counterparty credit risk exposure

Commodity pools are currently exempt from the restriction in NI 81-102 that a fund's exposure under its specified derivatives positions with any one counterparty (other than a specified clearing corporation) may not exceed 10% of the NAV of the fund for a period of 30 days or more. The CSA are considering whether this exemption should be repealed for Alternative Funds in order to reduce the risk of an investment fund's exposure to a single counterparty, particularly in connection with illiquid over-the-counter (OTC) derivatives. The CSA have expressed the view that significant counterparty credit risk exposure may materially alter the nature and risk profile of the fund.

The CSA have sought feedback on whether there may be other ways to mitigate exposure to counterparty risk for Alternative Funds by, for example, requiring the counterparty to post collateral.

seed capital - maintaining skin in the game

The CSA propose to introduce seed capital requirements for new Alternative Funds structured as mutual funds similar to those that currently apply to mutual funds and commodity pools, although with significantly higher thresholds. The manager of a new Alternative Fund would be required to provide seed capital of $150,000 and would not be able to redeem its investment until the Alternative Fund has raised at least $5,000,000 from outside investors. Alternative Funds that are structured as CEFs would not be subject to the seed capital requirements.

The CSA also propose to eliminate the current requirement in NI 81-104 that the manager always maintain a minimum $50,000 investment in the commodity pool. The proposal would enable the manager to withdraw its seed capital investment (which would be $150,000) provided that the Alternative Fund has raised at least $5,000,000 from outside investors and that if the value of the fund's securities held by outside investors drops below $5,000,000 for more than 30 consecutive days, the manager would have to re-invest its seed capital investment until the value reaches the prescribed amount again.

This proposal to permit the withdrawal of seed capital is consistent with exemptive relief that securities regulators have granted to commodity pools in the past. The CSA have sought feedback on whether it is appropriate to remove the restriction and what the appropriate dollar values for the conditions should be.

proficiency - who is qualified to sell alternative fund securities?

Currently, NI 81-104 imposes proficiency requirements for dealing representatives whose registration is limited to selling securities of mutual funds. Individuals that deal in securities of commodity pools are required to have completed the Canadian Securities Course, the Derivatives Fundamentals Course or the Chartered Financial Analyst Program, or to otherwise meet the proficiency requirements relating to commodity pools imposed by their self-regulatory organizations (i.e. IIROC or MFDA). In this regard, we note that IIROC rules already contain extensive proficiency, supervisory and reporting requirements for individuals that deal in derivatives and securities of commodity pools.

The CSA have sought feedback on whether the redesign of NI 81-104 should include proficiency requirements for all dealing representatives that sell securities of Alternative Funds (as opposed to only mutual fund restricted individuals). The CSA also asked for examples of courses or experience that should apply.

increasing disclosure requirements for alternative funds

The CSA are considering implementing a unique set of disclosure requirements for Alternative Funds that would be in addition to the existing continuous disclosure requirements applicable to investment funds that are reporting issuers. In addition to the naming convention discussed above, the CSA is proposing to require Alternative Funds to include prescribed text box disclosure in their prospectuses and sales communications that would, among other things, identify the fund as an Alternative Fund and state that the risks of investing in the Alternative Fund may differ significantly from the risk associated with other investment funds. The CSA are also considering requiring Alternative Funds to disclose in their prospectuses how their strategies differ from conventional investment funds subject to NI 81-102. In addition, the CSA are considering prohibiting Alternative Funds from comparing their performance to other investment funds that are not Alternative Funds in their sales communications, noting a concern that such comparisons may not in the CSA's view present a fair and balanced picture of the respective benefits and risks associated with different types of funds.

The CSA are also considering requiring an Alternative Fund to provide monthly website disclosure on: (i) the largest monthly and annual NAV drawdowns in the past five years, and (ii) the maximum and average daily leverage amounts during the most recent 12 month period. Continuous disclosure requirements could also see an increased focus on quantitative and qualitative disclosure regarding the use of leverage by Alternative Funds.

The CSA have sought feedback on whether monthly disclosure of such information will be useful to investors or the market, or whether there is other information that could be provided regularly on an Alternative Fund's website that would be meaningful for investors.

next steps

The deadline for submitting comments to the CSA on the proposed amendments in Phase 2 has been extended until August 23, 2013. Please contact one of the authors of this bulletin listed below or another member of our Investment Funds & Asset Management

Group if you have any questions regarding the proposed amendments or seek assistance with the preparation of a comment letter relating to the proposals.

by Kimberly Poster, Michael Burns, Jason Chertin, Stephen Genttner, Alison Kim and Hilary Kwinter

Toronto	Kimberly J. Poster	416.865.7890	kimberly.poster@mcmillan.ca
Toronto	Michael Burns	416.865.7261	michael.burns@mcmillan.ca
Toronto	Jason A. Chertin	416.865.7854	jason.chertin@mcmillan.ca
Toronto	Stephen Genttner	416.865.7023	stephen.genttner@mcmillan.ca
Toronto	Alison Kim	416.865.7171	alison.kim@mcmillan.ca
Toronto	Hilary Kwinter	416.865.7182	hilary.kwinter@mcmillan.ca

a cautionary note

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