

CSA Staff Notice 81-326

Update on an Alternative Funds Framework for Investment Funds

February 12, 2015

Introduction

On March 27, 2013, the Canadian Securities Administrators (the CSA or we) sought comments on, amongst other things, the development of a proposal for a more comprehensive regulatory framework for publicly offered investment funds that wish to invest in assets or use investment strategies not permitted under National Instrument 81-102 *Investment Funds*¹ (NI 81-102) (the Alternative Funds Proposal). This notice provides an update on the status of the creation of the Alternative Funds Proposal.

Background

The Alternative Funds Proposal is the final phase of the CSA's ongoing policy work to modernize investment fund product regulation (the Modernization Project). The Modernization Project has been carried out in phases, with Phase 1 and the first stage of Phase 2 now complete.

In Phase 1, the CSA focused primarily on publicly offered mutual funds, codifying, through amendments to NI 81-102 and other investment fund instruments, exemptive relief that had been frequently granted in recognition of market and product developments. As well, we made amendments to keep pace with developing global standards in mutual fund product regulation, notably introducing asset maturity restrictions and liquidity requirements for money market funds. The Phase 1 amendments came into force on April 30, 2012, except for the provisions relating to money market funds, which came into force on October 30, 2012.

In the first stage of Phase 2, the CSA introduced core investment restrictions and fundamental operational requirements for non-redeemable investment funds. We also enhanced disclosure requirements 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. The Phase 2 amendments substantially came into force on September 22, 2014.

The CSA first published the Alternative Funds Proposal on March 27, 2013 as part of Phase 2 of the Modernization Project. In June, 2013, we published CSA Staff Notice 11-324 *Extension of Comment Period* (CSA Staff Notice 11-324), which advised that the CSA had determined to consider the Alternative Funds Proposal at a later date, in conjunction with certain investment restrictions for non-redeemable investment funds proposed as part of the second stage of Phase 2 that we consider to be interrelated with the Alternative Funds Proposal (the Interrelated Investment Restrictions). The Interrelated Investment Restrictions include proposed restrictions for non-redeemable investment funds on investments in physical commodities, short selling, the use of derivatives and borrowing cash.

¹ Then known as National Instrument 81-102 *Mutual Funds*.

Alternative Funds Proposal

The Alternative Funds Proposal will have a broad impact on publicly offered investment funds that utilize alternative strategies or invest in alternative asset classes. In describing the Alternative Funds Proposal as part of Phase 2 of the Modernization Project, 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, such as naming conventions, proficiency standards for dealing representatives, and investment restrictions. We also proposed a number of areas where alternative investment funds could be permitted to use investment strategies or invest in asset classes not specifically permitted by NI 81-102 for mutual funds and non-redeemable investment funds, subject to certain upper limits, to be implemented through amendments to National Instrument 81-104 *Commodity Pools* (NI 81-104).

Key Themes from Public Comments

The Alternative Funds Proposal generated a significant number of comments from a wide range of stakeholders. The comments demonstrated a diversity of views on the types of investment funds that should be sold to the public, and how alternative investment funds should be regulated. Some of the key themes that emerged from the comments are described below.

The Attributes of an Alternative Investment Fund

A number of commenters discussed the attributes of so-called ‘alternative investment funds’ and the need for a specific regulatory regime for such funds. Some commenters expressed the view that such funds would create opportunities for investment fund managers and provide increased investment options for retail investors. Other commenters cautioned that the Alternative Funds Proposal would result in the sale of higher risk investment funds to retail investors.

The means of determining whether a fund would be an alternative investment fund generated significant comment. In particular, commenters sought more information about the criteria that would be used to differentiate a mutual fund and a non-redeemable investment fund from an alternative investment fund. Related comments expressed the view that the CSA should consider granting exemptive relief to mutual funds and non-redeemable investment funds that wish to use alternative strategies or invest in alternative asset classes in a limited manner, instead of requiring such funds to comply with the Alternative Funds Proposal.

Naming Convention

The suggestion of a naming convention for alternative investment funds in the Alternative Funds Proposal generated a lot of feedback from commenters. Most objected to either the concept of a naming convention entirely, or more specifically, to the proposed use of the term ‘alternative fund’. A number of commenters indicated that requiring the use of “alternative fund” in the name of such investment funds could result in these funds being unnecessarily labeled as higher risk or more volatile than other investment funds. Other commenters, however, told us the use of the term “alternative fund” would not be sufficient to properly identify for retail investors the

attributes or features of such funds or the level of risk and complexity that may be associated with such funds.

Borrowing

We sought feedback on whether alternative investment funds should be permitted to borrow cash, and what limits on borrowing should be set. We also asked whether different rules on borrowing should apply to mutual funds under the Alternative Funds Proposal versus those structured as non-redeemable investment funds.

Some commenters questioned the amounts specified in the borrowing limits for non-redeemable investment funds and the proposed limitation that borrowing may only be from Canadian financial institutions. Many expressed a concern that such a limitation would reduce competition amongst lenders or create unnecessary foreign exchange related expense for investment funds purchasing assets priced in currencies other than the Canadian dollar.

Use and Measurement of Leverage

The regulation of leveraged investment strategies and the measurement of an investment fund's use of leverage are important parts of the Alternative Funds Proposal. Investment funds that will likely fall within this new alternative fund framework often utilize leverage. We asked for feedback on a proposed total leverage ratio of 3:1 and whether different limits should apply to mutual funds under the Alternative Funds Proposal versus non-redeemable investment funds. We also sought feedback on whether the current methods mandated for measuring leverage should be reviewed.

In response to the questions posed, commenters expressed a number of different views on the use of leverage and whether it is necessary to restrict or have an upper limit. Some commenters suggested that the use of leverage itself was not a clear indicator of risk, and that any restriction on leverage should be considered as part of an investment portfolio. A number of commenters also suggested that positions entered into for hedging purposes should not be included in the measurement of an investment fund's use of leverage.

Short Selling

We asked for feedback to allow short-selling by alternative investment funds beyond the limits currently permitted under NI 81-102, similar to what has been granted to certain commodity pools through exemptive relief.

A number of commenters told us that the cash cover requirements relating to short selling currently found in NI 81-102 would impede the use of such strategies. We were also asked to clarify whether leverage created by short selling, where the short sale is a hedging position, would be included in the measurement of a fund's total use of leverage in the Alternative Funds Proposal.

Other Investment Restrictions

In the Alternative Funds Proposal, we proposed maintaining a number of the exemptions from sections of Part 2 of NI 81-102 found currently in NI 81-104. We also proposed other investment restrictions for alternative investment funds such as fund-on-fund investing or concentration restrictions that may be the same or less restrictive than is currently applicable under NI 81-104. We also asked for feedback on what other investment restrictions should apply as part of the alternative funds framework.

Some commenters suggested that alternative investment funds should not be subject to investment restrictions or limits. Again, we were told that such restrictions may limit the development of new types of alternative investment funds or alternative investment strategies, which in turn limits investor choice.

Proficiency Standards for Representatives Selling Alternative Funds

A number of commenters questioned maintaining or increasing the current proficiency requirements for dealers applicable to the sale of commodity pools in NI 81-104 for the Alternative Funds Proposal. These commenters cautioned that imposing any additional proficiency requirements for the sale of alternative investment funds could have an impact on the sales channels through which these funds could be sold, and their availability to retail investors. Other commenters however, suggested even higher levels of proficiency than what we proposed, to ensure that these types of funds are properly understood by those selling them.

Next Steps

As we continue to consider the feedback provided on the Alternative Funds Proposal and the Interrelated Investment Restrictions applicable to non-redeemable investment funds, we continue to speak directly to stakeholders. We expect to complete these consultations by mid- 2015, after which the CSA expects to publish for comment proposed rule amendments aimed at implementing the Alternative Funds Proposal. Considering the current slate of investment fund regulatory projects, we anticipate publication will take place at the end of the year.

Questions

Please refer your questions to any of the following:

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