

CSA PUBLISHES UPDATE ON PROPOSAL FOR ALTERNATIVE INVESTMENT FUNDS

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On February 12, 2015, the Canadian Securities Administrators ("**CSA**") published an update on the proposal for a comprehensive regulatory framework for publicly offered alternative investment funds ("**Alternative Funds Proposal**"). The Alternative Funds Proposal is the final phase of the CSA's ongoing effort to modernize regulation of investment fund products ("**Modernization Project**").

Background

Phase 1 of the Modernization Project, which is now complete, focused on mutual fund regulation. The first stage of Phase 2, also in force, created certain investment restrictions and operational requirements for non-redeemable investment funds ("**CEFs**"). As part of Phase 2, the CSA first published the Alternative Funds Proposal in March 2013, but later announced that the CSA would defer its review. In the second stage of Phase 2, the CSA will review the Alternative Funds Proposal as well as certain interrelated investment restrictions that would also be applicable to CEFs, including restrictions on investments in physical commodities, short-selling, the use of derivatives and borrowing cash.

Public Commentary on Alternative Funds Proposal

The CSA did not publish a draft rule for the Alternative Funds Proposal but rather posed certain questions for public comment. Several themes arose from a significant number of public comments received by the CSA.

Commentators wanted clarity on what differentiates a mutual fund and a CEF from an alternative investment fund. Some commentators proposed exemptive relief for mutual funds and CEFs that use alternative strategies rather than requiring compliance with the Alternative Funds Proposal.

Many commentators rejected the need for a naming convention for alternative investment funds while others objected to the use of "alternative fund" in the fund name as it could suggest greater risk or complexity where it might not be warranted.

Commentators raised concerns regarding the creation of borrowing limits for alternative funds as well as the proposed limitation on borrowing solely from Canadian financial institutions for CEFs. In the initial Alternative

Funds Proposal, the CSA proposed a total leverage ratio of 3:1 and sought feedback on whether there should be a different limit applicable to alternative funds structured as mutual funds as opposed to CEFs.

Some commentators also questioned whether leverage was a clear indicator of risk and suggested that any restriction on leverage should be considered in the context of the entirety of an investment portfolio. Commentators also proposed that hedging should not be included in a fund's use of leverage.

Some commentators suggested that the cash cover requirements applicable to mutual funds under National Instrument 81-102 *Investment Funds* ("**NI 81-102**") would discourage the use of short-selling. It is still an open question whether short-selling will be considered as part of total leverage.

The CSA has proposed maintaining the exemptions from certain investment restrictions in NI 81-102 that are currently available for commodity pools under National Instrument 81-104 *Commodity Pools* and proposed other investment restrictions for alternative funds. Some commentators generally oppose investment restrictions arguing that they would slow innovation and limit investor choice.

The CSA stated that commentators were mixed on the proficiency standards with some suggesting that higher proficiency requirements would negatively impact distribution channels, significantly limiting the availability of retail alternative funds to retail investors. Others suggested that proficiency standards were needed to ensure that those selling the products properly understood them.

Next steps

It seems that the Alternative Funds Proposal is still at an early stage and the CSA expects to complete their public consultations by mid-2015. As we follow its development, it will be interesting to see the extent to which the Alternative Funds Proposal will draw from the experience in the United States with so-called "liquid alternatives" under *Investment Company Act of 1940*. Subsequent proposed amendments are expected to be published for comment by the end of 2015.

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A Cautionary Note

The foregoing provides only an overview and does not constitute legal advice. Readers are cautioned against making any decisions based on this material alone. Rather, specific legal advice should be obtained.

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