Liquid Alternatives Are Finally Here

Why Read This?

On October 4, 2018 the Canadian Securities Administrators published final amendments to key mutual fund regulations which will affect both the mutual fund and the ETF space in Canada. These changes take effect on January 3, 2019. We discuss key points as they pertain to the ETF community.

Background

Canadian mutual funds and ETFs are currently governed by several regulatory instruments which define the rules of engagement for selling funds to Canadian investors. Specifically, National Instrument 81-102 *Investment Funds* governs open-ended mutual funds, closed-end funds and most ETFs. Additionally, National Instrument 81-104 *Commodity Pools* governs mutual funds which have adopted strategies that use derivatives or invest in commodities outside the confines of NI 81-102. In practice, most funds & ETFs sold to the public are governed by NI 81-102 (leveraged and inverse ETFs are NI 81-104). The rules in these instruments say that Canadian mutual funds and ETFs cannot use leverage or short selling, and are constrained on the use of derivatives.

A recent development in the funds space globally is the emergency of "Liquid Alternative" funds, or "liquid alts". These investment vehicles are "alternative" in the sense that they provide access to strategies normally reserved for hedge funds (such as short selling and the use of leverage). They are also "liquid" in the sense that they provide a daily means of entering and exiting the investment. In Canada, these types of funds did not traditionally fit the NI 81-102 and NI 81-104 frameworks given the limits on the use of leverage and shorting. As a result, liquid alternative largely funds didn't exist in Canada because regulations made it difficult to launch and distribute these products.

Beginning in 2013, the CSA has been engaged in a modernization initiative to update this framework in response to the evolution of the funds market in Canada and abroad. In 2016, the CSA proposed amendments to a range of regulations which introduce the concept of the "alternative mutual fund" to the Canadian funds framework, and openly permit the use of leverage and short-selling to a greater degree. These proposed amendments are now finalized with relatively few changes.

As part of rewriting the fabric of NI 81-102 and NI 81-104 to permit liquid alts, the CSA also addressed a number of technical but important issues which constrained NI 81-102 mutual funds and ETFs. The result is a more consistent and integrated framework for public investment funds in Canada.

Key Changes

The reforms to the instruments replace the notion of a commodity pool with a new term, "alternative mutual fund", and consolidate the provisions of both NI 81-102 and NI 81-104 into one instrument. Under the new rules, alternative mutual funds will be able to:

- Hold up to 20% of their assets in the securities of a single issuer (up from 10% today).
- **Borrow cash up to 50% of the fund NAV**, and invest that cash in the fund. Currently, mutual funds aren't allowed to borrow except for the purpose of managing short-term funding shortfalls.
- **Short-sell up to 50% of the fund NAV**, and also invest those proceeds. Currently, mutual funds are permitted to short-sell up to 20% of the fund's assets, but that short position must be covered by 150% cash.
- The aggregate short position (borrowed cash plus securities short) cannot exceed 50% of NAV.

Additionally, the rules relax certain restrictions on all mutual funds, and not just alternative ones:

- A mutual fund will be able to invest up to 100% of fund assets in any other NI 81-102 mutual fund (other than alternative fund), and up to 10% in an alternative fund.
- All mutual funds will be able to invest in physical precious metals other than gold. Additionally, all mutual funds will be able to own other commodities through derivatives, subject to limits on the size of the position.

The selling restrictions that exist in NI 81-104 are being carried over to the alternative funds framework. These restrictions stipulate that advisors making recommendations involving commodity pools (and now alternative funds) must have additional training which covers securities and derivatives. In practice, this means that mutual fund only firms and representatives will not be able to offer alternative funds to their clients. This primarily impacts distribution into the MFDA and the bank branch channel.

Liquid Alts as ETFs

The majority of the focus in this package of changes is undoubtedly on the introduction of the new category of “alternative” funds and their expanded investment horizons. There is no doubt that the Canadian funds industry is looking closely at launching products under this regime, and in fact some have already taken steps in that direction.

It should be noted that nothing in the revised NI 81-102 prohibits alternative funds from being listed on exchanges. In fact, the entire space of leveraged and inverse ETFs in Canada currently operates under the NI 81-104 framework, which is being transitioned to the “alternative mutual fund” rules. There are also certain ETFs in Canada which include elements of leverage and shorting under the previous NI 81-102 rules, with exemptions in place for the products at question.

In the context of ETFs, the constraints on distribution for alternative versus “regular” mutual funds do not amount to much. Nearly all retail ETF assets in Canada are held in accounts where either no advice is offered (direct investing), or in accounts where the representative is securities-licensed (IIROC). The latter category automatically meets the standard for distributing alternative funds. As a result, there is no distribution handicap for registering an ETF as being “alternative.” The same cannot be said for traditional funds which may be sold through IIROC or MFDA channels, and where the “alternative” label closes the door to MFDA distribution.

The question remains whether the use of shorting and leverage introduces wrinkles to the ETF arbitrage and market-making process. Practically speaking, the answer is “no.” ETFs with complex holdings will continued to be valued on the basis of those holdings, including any leverage implied. The costs of incremental balance sheet usage at market-making desks can be expected to be priced into the ETF’s bid-ask spread, consistent to what occurs today. In short, we do not believe that there are many practical impediments to the launch of liquid-alt ETFs in Canada beyond the constraints that already exist in the traditional ETF space (such as portfolio transparency issues and the pricing uncertainty of difficult-to-value funds).

Fund of Funds Rules Dramatically Relaxed

Lost in the chatter of liquid-alt discussions is a very important technical change to the traditional mutual fund framework. Currently, a mutual fund can invest in other mutual funds if certain conditions are met:

- The fund being invested in is filed under a simplified prospectus, rather than a long-form prospectus, or
- The fund being purchased is an index participation unit (“IPU”).

In practice, Canadian ETFs are almost always filed under a long-form prospectus. While many ETFs are technically index participation units, many others (including all actively-managed funds) are not. The existing rules significantly constrained the ability of fund families to invest in ETFs which offer complimentary strategies where those strategies are active. Additionally, we believe these rules have supported the business model of niche index providers who construct indices for the use of a specific fund, enabling that fund to meet the definition of an IPU.

The amendments to NI 81-102 do away with these restrictions, by allowing any mutual fund to invest in any other mutual fund (other than an alternative-fund), regardless of whether the fund being purchased is an IPU or otherwise, and regardless of the type of prospectus.

This small but important technical change to the regulations will allow issuers whose ETF lines operate in parallel to a similar mutual fund offering to consolidate assets into the ETF structure by having mutual funds purchase units of the ETFs. In practice, this process may take some time, as issues such as the triggering of tax events may restrict the wholesale move of assets. However, as this unfolds we may find that ETF assets in Canada grow on paper purely because fund companies allocate assets into the ETF structure, without any increase in overall AUM to the parent fund. As this process occurs, trading volume in ETFs will rise, and as a result some funds which were previously stigmatized as “illiquid” due to low volumes may begin to also see greater adoption in the broader investment community.

Conclusions

The package of reforms finalized by the CSA is a welcome update to the Canadian mutual fund framework. We believe the introduction of alternative funds into the Canadian framework opens the door to many product possibilities, many of which may find themselves being sold as ETFs in the market.

Equally importantly, the concurrent relaxation of fund-of-funds investment restrictions open the door to active ETF managers selling their products into the institutional space as suitable holdings for mutual funds. This change alone dramatically increases the addressable space of institutional investors that can buy active ETFs in Canada. We expect that as a result, institutional interest in active Canadian ETFs should pick up through 2019.

Please do not hesitate to contact us if you have further questions.

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