ALTERNATIVE MUTUAL FUNDS

A GUIDE FOR MUTUAL FUND MANAGERS

OCTOBER 12, 2018

Capital that works

This document is a high-level guide for mutual fund companies interested in launching liquid alternative products.

Scotiabank has long been dedicated to adding value to hedge fund and alternative asset managers through a full-service global operation encompassing all aspects of Prime Services, including Prime Brokerage, Securities Lending, Capital Introduction, and Synthetic Financing and Derivatives solutions.

As alternative investment products gain momentum in the Canadian retail space, we are uniquely positioned to partner with manufacturers to bring new and innovative products to market.

Our prime brokerage global footprint is extensive, with longstanding local market expertise. Our experienced professionals in North America, Europe and Asia are committed to providing comprehensive transaction expertise and innovative ideas to our clients globally.

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The growing market potential for liquid alternatives presents a significant opportunity for Canadian mutual fund manufacturers

Liquid alternative funds, also known as "liquid alts," offer alternative investment strategies through mutual fund structures and can provide expanded risk and return opportunities for retail investors. Important reforms being implemented by the Canadian Securities Administrators ("CSA") are making liquid alts more accessible to investors and changing the game for mutual fund manufacturers in Canada. The new rules open up hedge-fund-style strategies to the mass retail market – a market that is dominated by large institutions, with the top-15 institutions controlling approximately 95% of the $1.33 trillion mutual fund market in Canada.[1]

We expect traditional mutual fund managers will be interested in diversifying the investment solutions on their shelf by adding liquid alts to their product lineup. Liquid alts have the potential to:

- decrease correlation to stocks and bonds;
- enhance portfolio diversification; and
- reduce volatility and produce more consistent returns.

In addition to creating organic market growth, we expect a shift, or "reallocation," of assets under management from both existing mutual funds and hedge funds. As the regulations allow traditional mutual funds to invest up to 10% of a fund's net asset value ("NAV") into liquid alts, we anticipate this will become an effective seeding strategy for new alternative funds and will create immediate scale in the emerging liquid alts market.

Looking at the U.S. experience, the modernization of that country's fund regulations in 2013 helped propel liquid alts' assets under management growth to approximately US$225 billion by 2017[2]. Based on the U.S. case study, and the 10-to-1 ratio of the U.S. market's size to Canada, the liquid alts market could grow to more than C$20 billion in five years. Industry analysts have suggested potential market penetration ranging from C$15 billion to more than C$100 billion. Even at the lower end of forecasted levels, liquid alts could comprise a meaningful portion of the market over the next few years.

[1] Source: IFIC; company reports; Scotiabank GBM
[2] Investment Company Institute - 2018 Investment Company Fact Book - Table 46

A roadmap of the changes: Summary of National Instrument reform

The CSA implemented a three-stage modernization plan for investment funds that began in 2012. Phase one came into force that year and focused on codifying frequently granted exemptive relief for mutual funds, money market funds and exchange-traded funds (ETFs).

The initial stage of phase two was completed in September 2014 and focused on non-redeemable investment funds (also known as closed-end funds) and operational amendments. It also sought enhanced disclosure of securities lending.

The second stage of phase two – the Alternative Fund Proposal – was launched in 2013. These updated rules included the "Modernization of Investment Fund Product Regulation – Alternative Mutual Funds," which was published on October 4, 2018. This amendment established the ground rules for a new type of investment: liquid alts. This paper explores these regulatory changes and their implications for mutual fund manufacturers.

Overall industry reaction (as evidenced by the comment letters submitted to the CSA) to the amendments has been positive – with most commentators encouraging further liberalization of the investment restrictions on alternative funds in National Instrument 81-102[3].

What is changing?

We believe the most significant changes to the regulations include:

1. **Leverage will be permitted** to up to 300% of NAV. Previously, leverage was limited for traditional mutual funds.

2. **Short selling will be expanded** to up to 50% of NAV, with a 10% single issuer limit. The single issuer limit does not apply to government securities. Previously, short selling of up to 20% of NAV was permitted but, with a 5% single issuer limit and a 150% cash coverage requirement, this provision was rarely used.

3. **Derivatives will be expanded** to up to the 300% of NAV (per the leverage restriction noted above), with a 10% NAV single counterparty limit, unless the counterparty's equivalent debt has a designated rating. In the earlier National Instrument, derivatives were limited to 10% of NAV with rating requirements for the counterparty.

4. **Borrowing limits will be expanded** to up to 50% of NAV (combined with short selling). Previously, borrowing was limited to 5% of NAV and for limited purposes.

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[3] Source: CSA Notice of Amendments - Modernization of Investment Fund Product Regulation - Alternative Mutual Funds - Annex B

5. **Performance fees flexibility.** Unlike traditional mutual funds, alternative mutual funds will be permitted to charge performance fees that are not linked to the performance of a benchmark or index.

6. **Concentration limits will be increased** to up to 20% of NAV in any one issuer at time of purchase (compared to 10% for conventional mutual funds).

7. **Illiquid assets will be limited to up to 10% of their NAVs after purchase (**with a hard cap of up to **15% of NAV).** Currently, these rules are the same as for conventional mutual funds, but they will be re-examined as some liquid alts will likely hold a larger percentage in illiquid assets, depending on their strategy. Closed-end funds would have an illiquid asset limit of up to 20% of NAV with a 25% of NAV hard cap.

8. **Disclosure requirements would be similar to traditional mutual funds**. According to National Instrument 81-101, liquid alts would need to prepare a simplified prospectus, annual information form and fund facts for each series/class of the fund. Additional disclosure relating to alternative strategies and leverage is require in simplified prospectus and fund facts. The simplified prospectus of a liquid alt cannot be combined with the simplified prospectus of a conventional mutual fund.

9. **Liquid alts will be required to calculate their NAVs daily.** Under National Instrument 81-106, investment funds that use derivatives or short sell are required to calculate a daily NAV.

10. **Liquid alts will be able to invest 100% of their NAVs in other funds** (including other liquid alts). Moreover, conventional mutual funds would be able to invest up to 10% of their NAVs in alternative funds that fall under the jurisdiction of National Instrument 81-102.

When are the changes coming?

Subject to ministerial approval requirements, the updated rules are expected to come into force on January 3, 2019. In the meantime, some Canadian investment managers have been actively seeking exemptive relief from securities commissioners and, since the spring of 2018, the CSA has been granting exemptions that allowed some fund managers to offer products substantially similar to the new regulations.

Summary of Rule Changes

Restrictions & Obligations	Traditional Mutual Fund	Alternative Mutual Fund (“Liquid Alt Fund”)
Eligible investors	Mass market retail	Mass market retail
NAV calculation	Daily or weekly	Daily
Redemption rights	Daily or weekly	Daily
Redemption price	Daily	Daily, with option of up to T+2 days
Initial holding period	Not permitted	6-month maximum
Performance fees	Permitted when calculated with reference to benchmark or index	Permitted
Borrowing (cash or securities)	5% of NAV limit, for limited purposes	50% of NAV limit
Short selling	20% of NAV, with 5% single issuer & 150% cash coverage	50% of NAV limit, with 10% single issuer limit
Use of derivatives	Cash coverage requirements;10% of NAV counterparty exposure limit for OTC transactions; and rating requirements for counterparties	300% of NAV limit (leverage restriction); 10% of NAV exposure limit for single counterparty unless counterparty has a designated rating
Leverage	Limited	300% of NAV limit
Concentration limit by issuer	10% of NAV limit	20% of NAV, subject to carve outs
Illiquid assets	10% of NAV limit at initial investment (15% hard cap)	10% of NAV at initial investment (15% hard cap)
Disclosure requirements	Publicly filed financial statements Top 25 holdings disclosed quarterly Leverage disclosure in annual and interim financial reports	Publicly filed financial statements Top 25 holdings disclosed quarterly Leverage disclosure in annual and interim financial reports
Offering documents	Simplified prospectus, fund facts, annual information form	Simplified prospectus, fund facts, annual information form
Fund expenses	Organizational and offering expenses cannot be passed on to the fund	Organizational and offering expenses cannot be passed on to the fund
Sales practices	Governed by National Instrument 81-105 Mutual Fund Sales Practices	Governed by National Instrument 81-105 Mutual Fund Sales Practices

Understanding back-office implications

Given the regulatory changes, this is an ideal time for mutual fund manufacturers to plan a liquid alts strategy, including a new set of vendor relationships, operational workflows and fund structures. One of the most important differences relative to traditional (or “long only”) mutual funds is the addition of a prime brokerage relationship (“Prime Broker”).

Liquid alts using leverage, shorting and borrowing strategies will need financing from a Prime Broker. This is due to the fact that Custodians, traditional service providers for long-only mutual funds, typically have limited ability to provide financing services.

A note on margin financing

The facilitation of short selling, as well as margin financing, are loans from the Prime Broker to the fund. In both instances, cash and/or securities are required to be held as margin against these loans.

Margin requirements will vary based on several factors, including:

- Type of collateral
- Regulatory margin requirements (i.e., *Investment Industry Regulatory Organization of Canada [IIROC]*, New York Stock Exchange)
- Liquidity
- Concentration
- Hedge recognition
- Portfolio bias, or “direction”

A new part of the equation: the Prime Broker

As long-only managers are unlikely to have enlisted the financing services of a Prime Broker, a recap of the primary functions of this new liquid alts service provider may be helpful:

- Facilitating short positions
- Providing margin financing on long assets
- Acting as the derivative financing counterparty to swap transactions for equity and credit exposure
- Clearing and settling trades from dealers globally
- Asset servicing such as corporate actions processing and dividend processing

The first three services listed are examples of collateralized lending and require the fund to establish a credit relationship with the fund's Prime Broker. The last two Prime Broker services involve working with the fund from an operations perspective.

Cash versus synthetic Prime Brokerage

Prime brokerage services can be done on a "cash" basis – in which the fund holds, or shorts securities directly in the physical market – or on a "synthetic" basis – in which derivatives are used to replicate the performance of an underlying security.

Both of these service models have pros and cons. A Prime Broker should be able to speak to these and facilitate both alternatives across global markets.

Prime Broker selection process

When choosing a Prime Broker for a liquid alt, management at the fund and the Prime Broker should focus on several critical decisions.

- **Market access**

Prime Brokers need to be able to clear, settle and finance securities and/or derivatives in markets in which the fund wants to trade. For example, funds should ensure they will be able to trade in the specific global markets and currencies, as well as according to their preferences (cash versus synthetic).

- **Availability and depth of securities lending**

Prime Brokers have access to different inventories for securities based on flow, agent-lender arrangements, etc. The more diversified the pool of lenders, the more likely it becomes that the Prime Broker will secure a borrow. Funds should ensure a Prime Broker has access to the local and global experience in the types of securities and markets in which the fund wants to borrow. Further, the more established the relationships, the better the Prime Broker should rank with lenders, thereby, providing increased sourcing opportunity and lending stability.

- **Balance sheet**

A Prime Broker needs to have sufficient funding resources and an appetite to finance a fund's portfolio. Certain types of trades and assets place a greater strain on a Prime Broker's balance sheet and regulatory capital, which are both finite resources. It is important for funds to understand the impact their strategy has on a Prime Broker's balance sheet.

- **Client service**

A client service representative ("CSR") is the key day-to-day point of contact for the fund at their Prime Broker. A client service team should have a strong understanding of a fund's strategy and provide ongoing proactive operational and technology solutions to allow for efficiency and support as the fund grows. Funds should also ensure there is an effective client support model across time zones, in the case of a manager that trades globally and requires "follow-the-sun" CSR support and reporting.

- **Counterparty risk**

As with any lending relationship, the counterparty risk of the Prime Broker is a key consideration. Risks include credit-worthiness, operational, country, and market risk. One way to manage counterparty risk is to look at bank funding ratios and credit default swap spreads. Another calculation involves considering the amount of margin posted with the dealer to support a position – greater margins to support trades adds to counterparty risk. Further, depending on fund size, a multi-prime relationship can diversify counterparty credit risk – provided both Prime Brokers have similar financing abilities and provide non-correlated safe-harbour in a period of stress.

- **Pricing**

The main costs to a liquid alt manager with respect to a Prime Brokerage relationship are through interest spreads, as well as securities borrowing fees. A fund can get a good idea of Prime Broker pricing by providing a sample portfolio. Once the Prime Broker sees the sample, it can better determine how the business fits within the Prime's current lending portfolio, the impact on firm capital allocation and balance sheet, and corresponding pricing.

In addition to the normal day-to-day operations of a mutual fund, there are added obligations and operational items for a liquid alt to consider. As with structuring a liquid alt, the addition of a Prime Broker is a significant difference. Adding a Prime Broker is similar to adding a new Custodian, but with additional reporting and reconciliation considerations. Such considerations include establishing additional connectivity to provide daily trade files to your Prime Broker for trades the fund wants settled, in addition to information sent to the fund administrator and Custodian.

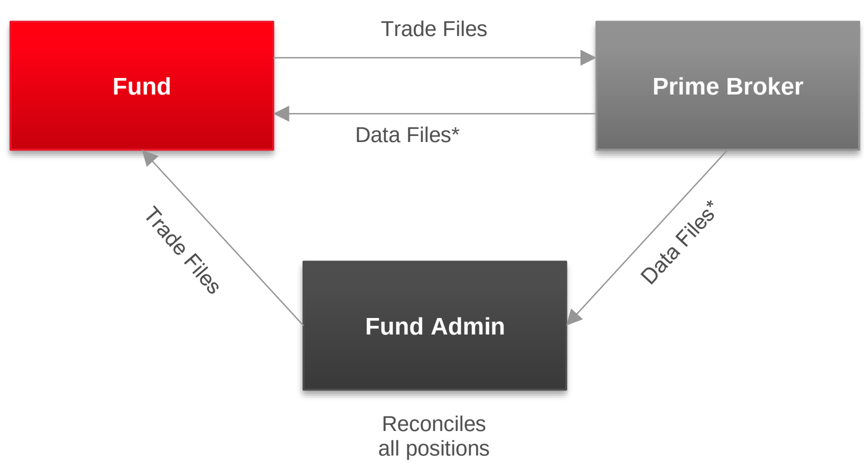
Operationally, Prime Brokers must work closely with a fund's operations and accounting teams, Custodian and administrator. Ideally, data and systems connectivity should be automated to reduce the potential for manual errors.

Tip: One new operational consideration is to establish an automated process to secure stock loan locates from the Prime Broker.

Here are examples of three additional operational reports that are available daily from the Prime Broker that are not normally a standard part of the traditional fund reporting package:

- Stock loan billing report – daily accrual of stock borrowing fees → Useful in calculating daily NAV
- Financing report – daily accrual of long and short financing → Useful in calculating daily NAV
- Margin report – daily mark-to-market of loan value and margin requirement → Details margin calculations and indicates if fund has margin excess or deficit

Operational flow



*Data Files include reporting such as positions, activity, cash balances, margin, stock loan billing, and financing reporting.

Getting “on the shelf” at investment dealers

Expect a more involved approval process

One important consideration is that traditional 81-102 mutual funds have generally been added to the product shelf at dealers quickly and painlessly. And they usually receive a risk rating based on their prospectuses. This may not be the case for new liquid alts.

Dealers tend to have more detailed processes in place for adding alternative funds to their product shelf – processes that include due diligence on the manager, the strategy and the fund, as well as benchmarking. At the end of the process, many alternative funds receive a “high risk” rating that limits the level of investment by advisors.

Consequently, investment advisors may be restricted in the amount of allocation to high-risk-rated investments they are allowed, both on an individual security basis, as well as on an aggregate portfolio basis. Furthermore, in order to use alternative products, some dealers have additional educational/proficiency requirements for their investment advisors. Any of these barriers to ownership are likely to reduce investment advisor’ demand for liquid alternative products.

Liquid alt funds will need to navigate stringent processes for getting on the shelves of many dealers. As each of these dealers tend to have their own unique processes, we recommend working with the product teams at target dealers as soon as possible, or risk having a product that is not available for purchase by many investment advisors at launch.

New territory, new approach

The opportunity for liquid alts in Canada is truly compelling. That said, this is relatively new territory for most Canadian mutual fund manufacturers, and a significant amount of legwork needs to be done to educate and break new ground in risk management, logistics, administration, workflows, reporting, vendor relationships, fund structures, sales and marketing, and distribution. Industry players who are flexible and proactive in rising to this challenge will be well positioned to capture the significant opportunity at hand.

Exemptive relief process

Many of the Canadian securities lawyers we spoke with in the summer of 2018 believe the Ontario Securities Commission is open to providing reasonable exemptions to its rules – as evidenced by recent exemptions provided to managers. For example, there is potential for exemptions for market neutral strategies that do not fit under the rules because of the restriction on shorting up to 50% of NAV. Market neutral strategies are hedge fund solutions designed to mitigate systematic risk factors. They match short positions in each sector against long positions in the same sector to create zero beta.

We would advise funds seeking exemptions to:

- Get the process of seeking exemptions started early. The relief process can take a long time, especially if a lot of funds are seeking similar consideration by their local securities commissions
- Consider your strategy and ask for the right exemptive relief for your particular fund
- Work collaboratively with your local securities commission

Sub-advisory agreements

Sub-advisory agreements with experienced hedge fund managers may be a good option for fund companies that want to launch a liquid alt, but do not have in-house shorting and leverage expertise. Increasingly, sub-advisory relationships are being explored with hedge fund managers seeking economies of scale, distribution, operational and marketing value add that can be offered by a manufacturing partner. On the other hand, partnering with a sub-advisor can take pressure off a manufacturer to create a product completely from scratch. In the U.S., quality sub-advisory relationships are highly coveted and, as a result, quality sub-advisory opportunities are becoming harder to find. As such, we recommend managers be proactive in exploring opportunities that are a good fit with their investment solutions set.

Conclusion

This is an exciting time for mutual fund managers in Canada, as liquid alts offer new investment opportunities to the industry.

Working within the alternatives space requires specialized knowledge. Scotiabank's Prime Services team is dedicated to adding value to global hedge fund and alternative asset managers through our full-service equity finance operations.

We look forward to working with you to launch innovative solutions in response to this exciting period of industry reform.

Get a head start on your liquid alts strategy. Contact us today.

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Global Prime Services Capabilities

Core Products & Expertise	Canada	U.S.	Europe	Asia
Capital Introduction	•			
Client Service	•	•	•	•
Customizable Reporting	•	•	•	•
Electronic Execution	•	•	•	
Foreign Exchange Execution	•	•	•	•
Margin Financing, Clearing and Custody	•	•	•	•
Multi-Asset Class Capability	•	•	•	•
Multi-Currency Platform	•	•	•	•
New Issues	•	•	•	•
Risk Management Tools, Analysis and Reporting	•	•	•	•
Sales and Trading	•	•	•	•
Securities Lending	•	•	•	•
Start-Up Consulting	•			
Synthetic Prime Brokerage	•	•	•	•

Appendix A: Life Cycle of a Short

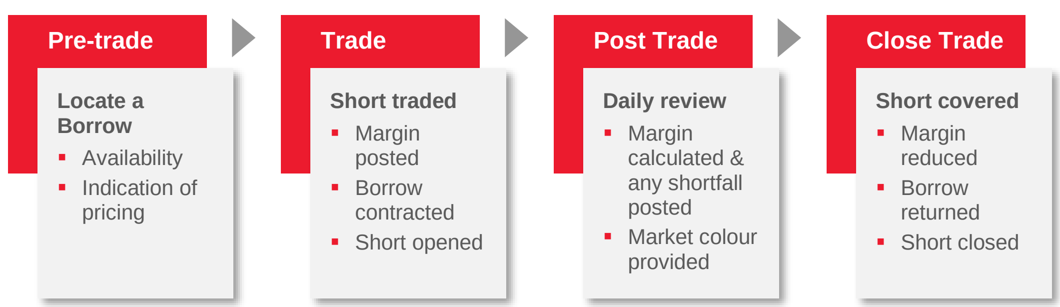
Note 1: Shorting rules vary widely across international markets. For our example below, we refer to the normal process for a short in the Canadian and U.S. markets. A fund should always be aware of reporting and legal obligations in every market in which they short securities.

Note 2: A borrow is required to settle a short transaction. In many markets, a locate is required by the relevant securities regulator and the local laws.

A fund initiates a short trade by asking its Prime Broker to locate the security. The Prime Broker then checks for availability of a borrow from their sources of inventory. If a borrow is available, the Prime Broker provides an indication of pricing and notional value for the borrow as at that date. If the client decides to transact the short through their executing broker, the Prime Broker should receive notice of the trade from the trader directly or in their daily trade files. On the settlement date, the Prime Broker contracts the borrow and settles the trade.

On T+1, the Prime Broker will review margin requirements for the fund and provide notice of any additional margin that may be required to be posted for the fund through a margin call. Margin must be posted or pledged on that same day.

On the close of a short trade, margin is reduced as of the trade date, and the Prime Broker closes the borrow by returning the borrowed shares on settlement date.



Appendix B: Life Cycle of a Financed Long

Cash financing (also called debit financing) involves the fund borrowing cash from the Prime Broker. The loan value available to the fund to borrow is based on the value of securities held in the fund that will be used as collateral and the margin requirement for those securities. Depending on several variables, loan values can be prescribed by regulators or determined by the Prime Broker.

Each day, the value of the pledged collateral versus the loan is reviewed and margin calls will be made for any deficit. When a loan is repaid, the margin is no longer required and can be removed from the pledge account.

Appendix C: Liquid Alternative Fund Legal Agreements

Liquid alt legal agreements are in addition to existing know-your-client ("KYC")/anti-money-laundering ("AML") processes for credit account opening.

To facilitate a liquid alt fund, agreements can include:

- Prime Brokerage Agreement ("PBA")
- Custody Agreement
- Pledge Agreement
- Master Agreement published by the International Swap Dealer Association ("ISDA") – the contract under which over-the-counter derivative transactions between two counterparties take place
- Credit Support Annex – a document that regulates credit support (collateral) for derivative transactions
- Master Confirmation Agreement – sets out the terms under which individual derivative transactions are carried out

These documents are detailed and time-intensive to negotiate. Your Prime Broker can walk you through each of the documents.