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The country's NI 81-102 amendments will allow hedge fund strategies to be sold to retail investors for the first time in a liquid alts format, but managers will need to overcome a number of hurdles. *HFM InvestHedge explores*

Later this year, a proposal designed to modernise Canada's $1.5trn mutual fund market is expected to come into force.

The amendments to National Instrument 81-102 (NI 81-102) will bring mutual funds, closed-end funds, commodity pools and ETFs under one rule and will, for the first time, allow retail investors to access alternative strategies such as hedge funds, in a mutual fund format.

HFM InvestHedge explores the opportunities and challenges presented by the proposals and what managers need to consider if they want to tackle this fledgling liquid alternatives market.

The opportunity set

As it stands, alternative strategies in Canada are only available to institutional investors or high-net-worth clients with incomes of more than $200,000 a year or a net worth of $1m, and at $40bn, the domestic hedge fund industry is relatively small compared to the country's mutual fund market.

But CIBC estimates that demand for liquid alternatives could exceed $100bn over the next three to five years and argues in a white paper focused on the proposals that "the significance of this [mutual fund market] transformation cannot be underestimated".

The NI 81-102 proposals allow liquid alternatives to be sold to the mass market, permit performance fees to be charged and allow borrowing, short selling and leverage, albeit with certain restrictions.

"The bottom line is the product will be available to far more investors than ever before and investors will have the ability to reap the diversification, risk reduction and non-correlated return benefits [from adding liquid alts] to their asset allocation mix," says Claire Van Wyk-Allan, director and head of hedge fund trade body Aima's Canada branch.

Jasmin Leitner, head of content, *HFM InvestHedge*

In short, a successful move into liquid alternatives can see firms access new markets, significantly diversify client bases and scale and aggregate assets.

Blue-chip US hedge funds or asset managers with hedge fund capabilities may be in the best position to take advantage of the proposals, Alexandra Krystal, managing director and business strategy/sales head in CIBC's prime services group, predicts.

She highlights their "depth and breadth" from a business development standpoint as well as them having the brand recognition necessary to break into the Canadian market.

Krystal and Robert Lemon, prime services group executive directors at CIBC, estimate they have had hundreds of conversations with managers in New York and Canada who have expressed an interest in the regime once approved, although the barriers to entry are not insignificant.

Considerations: Distribution and education

The two biggest considerations for hedge fund managers in Canada, or foreign firms looking to enter the market, are distribution and education, experts tell *HFM InvestHedge*.

"I don't expect there to be a huge lag in product offering, but I think we will see somewhat of a lag in product adoption by the marketplace because one of the key roadblocks is adviser education," Les Marton, a Toronto-based senior director at investment consultant bfinance, says.

Wealth managers and financial advisors with retail clients will be reticent to recommend or distribute alternative products unless they understand them, and Marton warns that firms will need to dedicate significant resources to that education effort.

"Smaller firms just don't have the bandwidth to be able to do continuous roadshows – it's not just a one-time thing, it's an ongoing support element," he says, adding that larger asset managers offering liquid alts products through the Canadian wealth management channel are likely to have an advantage in that regard.

Ensuring the target audience fully understands the alternative product they are being offered is not only key to building relationships, but will also ensure funds are properly rated.

On submitting offering documents for a retail Canadian alternative fund, managers will need to assign a risk rating for the vehicle. However, that may not be accepted by certain distribution platforms, who may assign a different rating.

"[The first step] is trying to get all the various distribution firms comfortable with what an alternative is and how to look at it from a risk perspective – this will allow managers an easier path to place products and ensure the gatekeepers are comfortable giving it an appropriate rating," adds CIBC's Lemon.

Having the right sales and client relations team in place is particularly important for smaller managers, as they will have to compete against traditional asset managers, Aima's Van Wyk-Allan explains.

A case in point would be Mackenzie Investments. In May, the $130bn firm launched the country's first alternative mutual fund, despite the fact that the NI 81-102 proposals are still just that, having received an exemption from the regulator that month.

"This product and this whole concept is new to many advisers in

Canada because it is the first retail mutual fund of its kind so we have to train our sales force and advisers," says Michael Schnitman, senior vice-president and head of product at Mackenzie.

The firm, whose 84-strong internal and external wholesaler network is spread throughout Canada, has a dedicated wholesaler development programme embedded within its distribution division.

Wholesalers wishing to sell the Mackenzie Multi-Strategy Absolute Return Fund have to score 100% in an exam the company has designed, while Mackenzie has also made a host of resources available to retail investors and advisers on its website, Schnitman adds.

In addition, Mackenzie deploys its team of 35 investment directors and

product managers to enable adviser education, he says.

Aima is also contributing to the education effort, Van Wyk-Allan tells *HFM InvestHedge*.

The trade body is preparing a pared-down version of its due diligence questionnaire to make it easier for a retail audience to use, as well as creating a one-page, 20-question version of the document which investment advisers can keep on their desks to ask wholesalers or portfolio managers during presentations.

"We also have an education presentation specifically for retail investment advisers which they will be able to watch that in webinar format or receive in person, so we are helping with the education of advisers on this front," she adds.

Collaboration

There are at least five or six firms already in the advanced stages of preparation to launch an alternative mutual product, according to industry sources, but there are also many mutual fund providers that don't have a history of offering such products and which are looking to partner with hedge funds that can provide such expertise.

Similar to US '40 Act funds, the NI 81-102 amendments will allow hedge funds to sub-advise products managed by traditional asset managers.

"It's a match made in heaven," says Michael Burns, a partner and co-chair of the investment funds and asset management group of law firm McMillan.

"There are a number of Canadian mutual fund manufacturers who are

Legal brief

Domestic hedge fund managers already registered in Canada will need to familiarise themselves with the additional regulatory requirements that come with running a publicly offered fund, including having an independent review committee for each fund, complying with complex marketing rules and producing publicly filed financial statements which include detailed portfolio disclosure as well as a management report of fund performance.

Foreign managers either have to become registered as portfolio managers and investment fund managers in Canada to offer product directly, or enter into a sub-advisory arrangement with an entity which is already regulated in Canada. Although the registration process won't be daunting for seasoned or larger managers, says Michael Burns, a partner at law firm McMillan, there are several nuances associated with coming under the purview of another regulator.

"There are proficiency requirements for individual advising representatives and compliance officers as well as ongoing reporting, filing and other compliance-related obligations which should be considered prior to making a decision to seek registration in Canada."

He adds that while a normal-course registration with Canadian regulators can take between six and eight weeks, foreign managers will also need to adopt additional Canadian-specific policies and procedures that are relevant for their operations and ensure compliance with applicable securities and related laws in Canada, which could take more time to craft in a manner that functions with existing policies and procedures and would need to be in place at the time the Canadian registration becomes effective.

Restrictions and obligations	Canadian liquid alternatives funds
Eligible investors	Available to the mass market
NAV calculation	Daily
Redemption rights	Daily (most common), weekly and monthly could apply as well
Initial holding period	Maximum 6-months
Redemption proceeds	T+2
Performance fees	Permitted
Borrowing (cash and/or securities)	Limited to 50% of NAV
Short-selling	Limited to 50% of NAV, no cash cover required
Leverage	Maximum of 3X
Concentration limit – issuer level	20% of NAV, subject to carve-outs
Illiquid assets	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

Source: CIBC white paper – Canadian liquid alternatives: the next market disrupter looking for partners to manage product because many have been focused exclusively on the long-only space to date and may not have the necessary skill set in-house to manage a product that can short up to 50 percent of NAV or use cash borrowing or derivatives to provide leverage," he says.

For foreign hedge fund managers looking to the Canadian retail market, entering into a sub-advisory arrangement with Canadian mutual fund manufacturer would not require them to become registered in Canada and would also provide the essential retail distribution relationships for a successful offering (*see Legal brief, page 6*).

However, CIBC warns in its white paper that a collaboration does not eliminate the challenges of distributing a Canadian mutual alts product.

"The AIM will be subject to oversight in the form of boards that are unaffiliated with the manager, and will be required to abide by the compliance programme of the sponsor," it wrote.

Fees

Regulations known as Client Relationship Model 2 (CRM2) introduced last year in Canada require that all investors be provided with annual account performance and charges and compensation reports.

This, coupled with wider discussions about hedge fund fee levels, has led Canadian investors to become more fee sensitive than they may have been in the past, experts indicate.

While the NI 81-102 proposals allow alternative mutual funds to charge performance fees, this is something that managers will need to consider carefully.

"We made a very clear decision not to use performance fees," says Mackenzie's Schnitman. "This is a mutual fund and so we have a standard, flat fee of 115bps. It makes it clear, it's consistent and it's competitive.

"There is already enough to understand about this product – it's not an offering memorandum product," he adds.

But bfinance's Marton doesn't believe the alternative mutual fund structure needs to be restricted to flat-fee offerings, adding that it will be dependent on the strategy and terms offered by managers.

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"I think that really depends on the nature of the underlying portfolio. If these funds have well-constructed objectives, potentially even with performance fees over an appropriate hurdle rate, that makes a lot of sense to many of the investors we work with, as they feel it offers a better alignment of interest."

He adds performance fees will be less appropriate for directional strategies which have exposure to a lot of structural beta, but that more generally HNWIs and retail investors should be should be prepared to evaluate flat-fee offerings as well as those which charge performance fees.

CIBC's Lemon stresses that managers will need to think carefully about how they disclose and discuss fees with potential clients, adding that he expects to see a manager's background – long-only or hedge – informing the approach they take.

Strategy interest

Retail demand for alternative mutual product in Canada is not necessarily going to be driven by a desire for high-octane returns. Rather, investors may be willing to consider them when equity markets start cooling down, bfinance's Les Marton suggests.

"I think investors will look for a different return stream from what they already own in their stock and bond investments," he says, adding that the role of liquid alts strategies as diversifiers and risk mitigators should be appealing.

"Many analysts we have been speaking to say that this will really take off if there is a significant correction or a more prolonged cooling of the bull equity market, where investors are a little less focused on chasing returns."

Firms looking to launch Canadian liquid alternatives products will also need to consider the suitability of their strategy, from a liquidity and portfolio construction perspective (*see table, page 6*).

Brokers suggest that simple, liquid products trading long/short equity or relative value fixed income are most likely to gain traction at the early stages of Canada's liquid alts development, as they are easier to explain than more complex strategies. ■

Over the border

The growth of liquid alternatives in the US was a key industry theme in the years following the financial crisis, as appetite for better liquidity and transparency from investors of all stripes drove firms to launch onshore products. The liquid alternatives market increased by almost 50% to cross the $100bn threshold 2013, rose by 8% in 2014, but was flat in 2015. Over the last two years to the end of 2017, assets have sat at around $165bn. Reasons for the '40 Act stagnation vary from struggling to run strategies parri passu with offshore products to difficulties associated with the fee model, which unlike the NI 81-102 proposals, restricts the use of incentive fees. Meanwhile, a controversial proposal by the SEC from December 2015, which sought to limit the use of derivatives in mutual funds, may make a come-back. Staff at the regulator recently met with industry participants to inform them that Rule 18f-4 is back on the agenda.