

Chapter 6

Regulating Hedge Funds

6.1 Once the exclusive domain of the super wealthy, hedge funds have now begun to enter the “mainstream” as potential investment products for the average investor. The growth in the hedge fund market coupled with the recent high profile failures of two hedge funds in Canada – Norshield Asset Management (Canada) Ltd. and Portus Alternative Asset Management Inc., the collapse of which was studied on our behalf by G. Wesley Voorheis¹ – as well as the increasing attention that hedge funds have started to garner among regulators (including, it must be noted, Canadian regulators)² led the Task Force to review the regulation of hedge funds.

6.2 It should be stated that the Task Force is not inclined to recommend the regulation of hedge funds merely because they are regarded by some as “risky” investments. Hedge funds attract our attention because they are relatively new, emerging products and any serious attempt to “modernize” Canadian securities legislation requires an examination of what is new in the capital markets. It is also part of our mandate to make recommendations to increase the competitiveness of Canada’s capital markets – a logical antecedent of which is increased investor participation which, in turn, is partially fostered by investors having a greater variety of investment products to choose from. Consequently, we take the view that the pool of investors permitted to invest in hedge funds should be as large as possible.

6.3 Moreover, the hedge fund industry, while in many ways still in its infancy in Canada, represents a highly valuable pool of talent in Canada’s capital markets. Any approach to regulation of this industry should be crafted with a deft touch to not only protect investors and allow maximum investor access to hedge fund products, but also ensure that this talent pool is fostered and not discouraged from conducting legitimate operations in this country.

6.4 Still by way of introduction we should note two things. First, we have relied heavily in our approach to this topic on the research report prepared for us by André Fok Kam, which we encourage readers to review.³

¹See G. W. Voorheis, “The Collapse of Portus Alternative Management Inc. and Norshield Asset Management (Canada) Ltd.” in Volume III.

²See Investment Dealers Association of Canada *Regulatory Analysis of Hedge Funds*, May 18, 2005 and Report of the Task Force on Debt-Like Derivatives, January 5, 1999. The Canadian Securities Administrators have also published Notice 46-303 detailing their concerns about the distribution and sale of principal protected notes.

³See A. Fok Kam, “A Canadian Framework for Hedge Fund Regulation” in Volume III.

Second, while we have a number of recommendations which could have the effect of increasing the regulatory oversight of hedge funds, we have not undertaken a cost-benefit analysis of this regulation. Prior to the implementation of any regulation we, of course, encourage the completion of a rigorous cost-benefit analysis as we have outlined in Chapter 3.

6.5 Prior to delving into our recommendations on this topic, it would first be useful to present an answer to the question that many investors are asking: what is a hedge fund? This will be followed by our review of the current hedge fund regulatory regime and our related recommendations. Our recommendations will be focused on the ways in which hedge funds are distributed, the transparency of hedge fund offering documentation and the regulation of hedge fund managers.

What is a Hedge Fund?

6.6 Putting forth a concise definition of a hedge fund is not an easy task. Hedge funds have a multitude of characteristics, not all of which are present in any particular hedge fund. Nonetheless, we have regarded hedge funds as generally having the following characteristics.⁴ Hedge funds are investment pools – they invest money provided by their securityholders. Generally, the goal of a hedge fund is to generate absolute, positive returns for its investors in all market conditions. The difference between a hedge fund and other investment funds, such as mutual funds, is that hedge funds generally have very broad investment mandates. Moreover, unlike mutual funds, they are not restricted from using techniques such as leverage and short selling. They also often use derivative instruments. Since hedge funds are not limited to buying securities, they can potentially profit in any market environment, including one with sharply declining prices. Since they often move hundreds of millions (if not billions) of dollars in and out of the capital markets quickly, hedge funds can have a large impact on the day-to-day trading prices of securities.

6.7 Other characteristics of hedge funds generally include:

- **Lock-ups** – Investors are often required to enter into lock-up agreements which prevent them from redeeming their securities in the hedge fund for a period of time (usually at least a year). Even at the end of a lock-up period, the opportunity for redemptions is often limited.
- **Manager/Adviser as Investor** – The hedge fund manager/adviser often invests its own money in the hedge fund along with outside investors.
- **Fees** – The hedge fund manager/adviser's compensation often includes a share of the investment returns in the form of performance fees. These fee arrangements are often structured such that the manager/adviser is entitled to additional incentive management fees based on higher returns – the higher the hedge fund's returns, the higher the manager/adviser's fees.

⁴The characteristics we outline in this and the next two paragraphs are taken in part from *Ibid.* at 95.

6.8 Hedge funds encompass a broad range of investment strategies. While the goal is always to generate the highest possible absolute returns, the investment risks run to obtain these returns vary greatly depending on the strategy used. Generally speaking, at one end of the spectrum, hedge funds may use arbitrage strategies, which are arguably no riskier than the investment strategies used by other forms of investment funds. At the other end of the spectrum, highly opportunistic strategies which make use of leverage and derivative instruments can be extremely risky.

Size of the Canadian Hedge Fund Market

6.9 Estimating the size of the hedge fund market in Canada is difficult. This is because, as we will explain in more detail below, stand-alone hedge funds are often nested within funds of hedge funds. Nonetheless, in June 2004 the overall Canadian hedge fund market was estimated to include some \$26.6 billion in assets under management (within a global hedge fund market of approximately US\$1.1 trillion). Of the \$26.6 billion in Canadian hedge funds' assets under management, approximately \$10.9 billion was invested by Canadian pension plans, \$14.1 billion by Canadian individuals (\$6.4 billion in stand-alone hedge funds and funds of hedge funds and \$7.7 billion in "principal protected notes") and \$1.6 billion by foreign clients of Canadian hedge fund managers.⁵

The Structure of Hedge Funds in Canada

(a) The Operational Structure

6.10 A quick overview of the operational structure of hedge funds may aid in the understanding of some of our recommendations below. The operation of a hedge fund is generally split between four different parties:

- **Manager** – the manager is the party who establishes the hedge fund and is responsible for its strategic direction and operation.
- **Adviser** – the adviser advises the manager on the management of the hedge fund's investment portfolio. In many cases the manager and the adviser are the same entity or under common ownership but the different roles may entitle them to separate fees.
- **Prime Broker** – the prime broker role is usually filled by an investment bank. It performs many of the functions involved in the operation of the hedge fund, except for portfolio management. The prime broker may do such things as execute trades, act as custodian of the hedge fund's investment securities, provide margin financing for the hedge fund to use as leverage and undertake securities lending programs.
- **Administrator** – the administrator takes care of the "back office" functions of the hedge fund – processing subscriptions and redemptions, maintaining investor records, calculating net asset values and management and performance fees. In many cases the manager and the administrator are the same entity or under common ownership.

⁵*Ibid.* at 164 citing Investor Economics, "Hedge Funds Report", Winter 2005.

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(b) The Commercial Structure

6.11 Hedge funds in Canada are generally organized in one of three commercial structures: (i) stand-alone hedge funds, (ii) funds of hedge funds and (iii) principal-protected notes (although, it is important to note that most principal-protected notes are not based on hedge funds).

- **Stand-alone Hedge Funds** – these are hedge funds that are usually advised by one adviser.
- **Funds of Hedge Funds** – funds of hedge funds invest in the securities of stand-alone hedge funds (i.e., underlying funds). It is estimated that more than 90% of the assets of Canadian funds of hedge funds are invested in underlying US-based hedge funds.⁶
- **Principal Protected Notes** – a “principal protected note” is a form of “structured” investment product. A structured investment product is one which derives its value based on the movement of an underlying investment, such as a hedge fund. “Principal protected notes” guarantee to their investors that, at maturity, the principal of their investment will be returned to them. As Fok Kam explains:

The major banks were the first to issue structured products in Canada. In 2002, independent (that is, non-bank) managers began to structure and distribute principal-protected notes, using hedge funds (usually funds of hedge funds) as the underlying investment.

Independent managers of principal-protected notes work in partnership with banks [or Crown corporations]. The notes are sponsored and distributed by the manager but issued by the bank [or Crown Corporation].

Distributing Hedge Funds – Exempt Trades and Exempt Securities

Exempt Trades

6.12 The distribution of securities in hedge funds, like the distribution of any other securities in Canada, must be completed using a prospectus or in reliance on a prospectus exemption. It is our understanding that there have been few (if any) hedge fund offerings by way of prospectus in Canada – few hedge fund managers are inclined to make the types of detailed disclosure required in a prospectus and the subsequent continuous disclosure rules upon the hedge fund becoming a reporting issuer, unless they have to. Accordingly, the subset of the investing public who may invest in hedge funds is, for all intents and purposes, currently limited to those who meet the definition of “accredited investor” under National Instrument 45-106 or who have the means to invest more than \$150,000 – i.e., wealthy Canadians.

⁶*ibid.* at 178.

Exempt Securities

6.13 The one variance in the above is with respect to the distribution of principal protected notes. Many principal protected notes that expose investors to an underlying hedge fund are sold both without a prospectus and to investors who are not deemed wealthy or sophisticated by securities legislation. These products are typically structured as an “evidence of deposit” such that they fall outside of the legislative framework that applies to publicly-traded securities and mutual funds. The returns on such notes are sometimes linked to the performance of hedge funds or funds of funds that themselves are not reporting issuers offering securities by prospectus. Since these products are typically structured as evidence of deposits rather than securities, their issuance is not subject to or is exempted from the obligation to file a prospectus with provincial securities regulators.⁷

6.14 The Canadian Securities Administrators have estimated that as at March 2005, 24 percent of the principal protected note market was structured such that the underlying investment was a hedge fund.⁸

Why the Contradiction?

6.15 This state of affairs strikes us as ill-advised and contradictory. On the one hand, direct investments in hedge funds are generally limited to those investors qualifying to purchase an exempt security, i.e., the wealthy. At the same time, however, any investor (regardless of wealth) is permitted to purchase principal protected notes, which are complex structured investment products linked to hedge funds, via the “backdoor” without the full protections afforded by securities laws because principal protected notes are regarded not as securities or as exempt securities.

Should Hedge Funds be Subject to Increased Regulatory Oversight?

6.16 Putting hedge funds through the regulatory filter may actually increase market participation. Starting from the premise that hedge fund investing does indeed represent a viable and attractive alternative investment strategy, then regulation that allows the largest pool of investors possible to purchase hedge funds should be put in place.

6.17 What, in our view, would be the features of the regulation of hedge funds?

Transparent Disclosure

6.18 While we make no attempt to make recommendations for the regulation of the exempt market for hedge funds we believe that a framework should be established to allow hedge funds to be widely sold to the public. Just as a mutual fund regulatory framework for the retail market was established so too should a retail hedge fund regulatory framework be established. Retail investors need to be able to access all of the

⁷However, it should be noted that chartered banks that issue principal protected notes in Canada are required under banking legislation to provide a plain language disclosure statement setting out certain key terms of the principal protected notes. See *Index-linked Deposits Interest Disclosure Regulations*, SOR/2002-102. It is current market practice for the potential purchasers of these notes to be provided with an information statement containing this required disclosure.

⁸Canadian Securities Administrators Notice 46-303.

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information necessary to make informed investment decisions regarding hedge funds and principal protected notes linked to hedge funds.

6.19 André Fok Kam suggests grafting a regulatory framework for hedge funds onto the existing regulatory framework for mutual funds.⁹ In particular, he suggests that the existing National Instrument 81-104 – *Commodity Pools* presents a useful existing structure. This may indeed be a logical starting place as many of the regulatory principles identified in National Instrument 81-104 – supervisory requirements, rules relating to the payment of incentive fees and disclosure requirements – are generally applicable to hedge funds.

6.20 Without determining the precise workings of such a framework, we feel it important that any regulatory regime applicable to hedge funds contain the following features (to the extent not already required under securities laws), in addition to those noted above:

- Full disclosure of all performance, management, administrative, referral and other fees (including the compensation of the investment adviser and manager).
- A description of the relationship between the hedge fund manager, adviser, administrator and prime broker and appropriate cautionary language regarding any conflicts of interest between them.
- Mandatory disclosure of any “side letter” and other collateral agreements between the hedge fund and investors who receive special fee or liquidity arrangements.
- An independent process or mechanism to value the assets of the hedge fund.
- A description of the hedge fund structure and its investment strategies.
- In the case of principal protected note products linked to hedge funds, a full description of the underlying hedge fund or fund of a hedge fund incorporating all of the features listed above.
- A custodian or custodian-like capability be required at each hedge fund.

Recommendation: *The Task Force recommends that a regulatory framework be established for the public offering of hedge funds just as a regulatory framework was established for the public offering of mutual funds and that while the framework will incorporate full regulation some of the features will be as follows: full disclosure of all performance, management, administrative, referral and other fees (including the compensation of the investment adviser and manager); a description of the relationship between the hedge fund manager, adviser, administrator and prime broker and appropriate cautionary language regarding any conflicts of interest between them; mandatory disclosure of any “side letter” and other collateral agreements between the hedge fund and investors who receive special fee or liquidity arrangements; an independent mechanism or process to value the assets of the hedge fund; a description of the hedge fund structure and its investment strategies; and in the case of principal protected note products linked to hedge funds, a full description of the underlying hedge fund incorporating all of the features listed above.*

⁹See Fok Kam, *supra* note 2 at 198.

Principal Protected Notes Linked to Hedge Funds

6.21 As noted above, our concern with principal protected notes linked to hedge funds is that they slip through “regulatory cracks”. We have two recommendations to try to ensure that retail investors purchasing principal protected notes linked to hedge funds are afforded some protection.

6.22 First, we recommend that the distribution of principal protected notes where the economic value is based upon an underlying hedge fund be regulated according to the nature of the underlying investment rather than according to the exemption accorded to the principal protected note with which the underlying investment is “wrapped”. After all, it is the underlying investment that is one of the key drivers in the investment risk and reward dialectic. As a result, we believe that it is appropriate to look beneath the issuer of the principal protected note. In these circumstances one should regulate the underlying investment.

Recommendation: *The Task Force recommends that the distribution of principal protected notes where the economic value is based upon an underlying hedge fund be regulated according to the nature of the underlying investment rather than according to the exempt character of the related principal protected note with which the underlying investment is “wrapped”.*

6.23 Second, we recommend that all financial intermediaries selling hedge fund products and other structured products such as principal protected notes linked to an underlying hedge fund, be required to meet certain proficiency requirements to ensure that they properly understand the products they are selling, i.e., they must fulfil the “know-your-product” principle.

Recommendation: *All financial intermediaries selling hedge fund products, and other structured products, such as principal protected notes linked to an underlying hedge fund, be required to meet certain proficiency requirements to ensure that they properly understand the products they are selling.*

*Manager Registration*¹⁰

6.24 Given the large sums of money involved coupled with the use of what can often times be characterized as “aggressive” investment strategies relying

“In particular, we take the position that fund managers should be required to be registered with the securities commissions. While registration requirements go part way in enhancing investor protection, active regulatory oversight of fund managers is also necessary. Such oversight should include on-site compliance reviews coupled with enforcement action where appropriate. Regulatory standard must be created to ensure that fund managers have the resources to carry on their functions and that investors have an avenue for recourse when they fail to do so. These standards would include requirements for minimum capital, insurance and bonding requirements, competency and proficiency of staff and adequacy of internal systems, controls and procedures.”

– Mutual Fund Dealers Association of Canada (written submission to the Task Force in Volume VII)

¹⁰For recent proposals which deal, in part, with the registration of fund managers, see CSA Registration Reform Project – Parts I and II available on-line at www.rrp-info.ca/reform/national/nrr_index.jsp

on leverage and derivative products, hedge funds are particularly vulnerable to operational risks associated with poor management. Despite this, many hedge fund managers (unlike advisers) are not registrants under securities legislation and therefore escape regulatory oversight. Accordingly, there is no safeguard in place to ensure that a hedge fund manager has adequate capitalization, appropriate internal controls or, at the most basic level, whether the manager's principals are fit to manage investors' money.

6.25 Moreover, as noted in a recent report published by the Investment Dealers Association of Canada, the need for regulatory oversight of hedge fund managers is particularly acute given the "multiple roles associated with hedge fund activities through entities under common ownership and management..."¹¹ To the extent that a hedge fund manager is related to the fund adviser, as is often the case, there is the potential that, without mandated internal controls and governance procedures in place in the management of the hedge fund, this common ownership may result in conflicts of interest detrimental to the investor. For example, there may be a bias "to overvalue securities held in the fund and thereby overstate the fund's [net asset value] – which is the basis on which compensation is determined for both the related fund adviser and manager."¹²

6.26 Accordingly, the Task Force recommends that consideration be given to the registration of hedge fund managers in order to ensure that there is an appropriate level of regulatory oversight of the activities of the manager as well as its capitalization and governance procedures. We acknowledge that a similar proposal requiring hedge fund managers to register as advisers in the United States was met with resistance and, ultimately, judicial intervention.¹³ However, we do not believe that these events should forestall consideration of our recommendation.

Recommendation: *The Task Force recommends that consideration be given to the registration of hedge fund managers in order to ensure that there is an appropriate level of regulatory oversight of the activities of the manager as well as its capitalization and governance procedures.*

¹¹See Investment Dealers Association of Canada, *supra* note 2 at 20.

¹²*Ibid.*

¹³See the June 23, 2006 decision of the United States Court of Appeals for the District of Columbia Circuit in *Goldstein v. U.S. Securities and Exchange Commission* in which the court overturned the United States Securities and Exchange Commission's rule requiring hedge fund managers to register under the Investment Advisers Act of 1940. The rule provides that, in determining whether an Investment Adviser that manages hedge funds is exempt from registration because it has fewer than 15 clients, the adviser must count all of the investors in the hedge funds managed by such adviser. Previously, the adviser could count each hedge fund as one client.