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Research Study

A Canadian Framework for Hedge Fund Regulation

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Evolving Investor Protection

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All opinions expressed in this report are my sole responsibility, as are all errors and omissions.

1. Executive Summary

Mandate

Our mandate was to assist the Task Force to Modernize Securities Legislation in Canada by making recommendations on a Canadian framework for hedge fund regulation. In formulating our recommendations, we were to strike an appropriate balance among various needs: the protection of investors, appropriate access by investors to hedge fund strategies and the encouragement of product innovation in capital markets.

What Are Hedge Funds?

Hedge funds are investment pools that aim at generating absolute, positive returns in all market conditions while at the same time protecting capital.

Hedge funds share certain characteristics. They have broad investment mandates and use financial techniques that are usually off limits to traditional investment funds, such as leverage and short selling. They often feature lock-up periods during which the securities may not be redeemed by investors. At the end of the lock-up period, there are limited redemption opportunities.

The hedge fund manager[1] generally invests his own money in the fund alongside other investors, thereby aligning his interests with those of outside investors. The manager's compensation normally includes a share of the investment returns in the form of performance fees.

Hedge funds are sometimes described as alternative investments in opposition to traditional investments such as stocks and bonds.

[1] The manager of a fund is also referred to as the sponsor, manufacturer or promoter. The fund manager is not to be confused with the adviser who advises the fund manager on managing the portfolio of investments. To avoid confusion, we shall use the word "manager" to refer to the manager of a fund and "adviser" to refer to the adviser of a portfolio of investments. The manager and the adviser may or may not be the same entity

Why Do Hedge Funds Matter?

Benefits of Hedge Funds to the Capital Markets

Hedge funds enhance market efficiency. Because hedge funds actively perform research on investment opportunities and their trades reflect the results of this research, securities are better priced than they would otherwise be.

Hedge funds also enhance market liquidity because they trade in large volumes. In addition, hedge funds are sometimes managed with a contrarian approach and the managers are willing to take positions that are the opposite of those of other market participants.

Hedge Funds Make Investment Portfolios More Efficient

Hedge funds encompass a broad range of investment strategies. These strategies all target absolute returns but they vary greatly in terms of risk. At one end of the spectrum, some arbitrage-based strategies are arguably no riskier than some traditional strategies involving equities. Sector mutual funds such as those investing in technology stocks come to mind. At the other end of the spectrum, some opportunistic strategies can be very risky.

Most investors like high return and low risk. A portfolio that minimizes the risk for a given expected return using a set of available assets is said to be efficient. Hedge funds matter to investors because they have the potential to improve the efficiency of a portfolio. Hedge funds can improve portfolio efficiency because their returns are not related to those of traditional asset classes. Whereas stock and bond returns depend upon market conditions, hedge fund returns depend on the adviser's skill at applying a given investment strategy. By including hedge funds in a portfolio, it is possible to decrease the risk of the portfolio for a given expected return. This is true of all portfolios, be they those of pension funds, high net worth investors, or retail investors.

Hedge funds are sometimes viewed as speculative, risky investments from which retail investors in particular must be shielded. We believe that this view overlooks the varied nature of hedge funds and their potential to actually reduce the risk of a portfolio. Our position is in line with that of the International Organization of Securities Commissions ("IOSCO").

Objectives and Concerns of Regulators in Other Jurisdictions

Canada is part of a global economy and hedge funds are a global industry. Accordingly, we reviewed hedge fund regulation in foreign jurisdictions in each of the three regions with the highest concentration of hedge funds: the United States, the European Union, and the Asia-Pacific region.

Regulators appear to have two broad sets of concern. The first relates to systemic risk, which is the potentially disruptive impact on the market of the failure of a large hedge fund or group of hedge funds.

The second set of concerns, which we believe requires more immediate attention in the Canadian context, relates to the need to ensure the protection of investors, in particular, retail investors.

In this connection, the same concerns keep appearing among regulators in different jurisdictions: inadequate valuation of the hedge fund's assets, inability or unwillingness of the manager to set up an internal control system, doubts about the retail investor's understanding of the risk and return characteristics of hedge funds, incentives for fraud, inadequate disclosure of fees and expenses, and inadequate disclosure of conflicts of interest.

Regulators are well aware of the danger of regulatory arbitrage, whereby restrictive regulation of hedge funds in one jurisdiction may encourage managers to move to other jurisdictions with less restrictive regulations. This risk is compounded by the fact that unlike, say, mutual funds, which are a domestic industry, hedge funds are a global industry.

The need to encourage market innovation always looms large among regulators' objectives. In some cases, there is also a clear objective to foster the growth of a local hedge fund management industry.

Outside North America, some regulators have opened up retail access to hedge funds or are proposing to do so. In the process, they have tried to balance two competing objectives. On the one hand, they want retail investors to have access to legitimate investment strategies that may benefit them. On the other hand, they want to ensure that these investors are adequately protected.

In Europe, recent amendments to the UCITS[2] regime, which governs retail investment funds marketable throughout the European Economic Area ("EEA"), now enable the use of hedge fund strategies by such funds. In addition, domestic initiatives have widened retail access to hedge fund strategies in certain European countries. The preferred vehicle to this end has been the fund of hedge funds. In Germany, the Investment Modernisation Act of 2004 has opened the retail market to funds of hedge funds. Retail investors may also purchase funds of hedge funds in Switzerland, Luxembourg, Ireland, and France. In France, this is subject to a low minimum investment threshold. Ireland recently eliminated its threshold. In the United Kingdom, the Financial Services Authority ("FSA"), the integrated financial services regulator, has announced its intention to start consultations on allowing funds of hedge funds to be sold to retail investors.

Hong Kong and Singapore were among the first jurisdictions to regulate retail hedge funds. In these countries, retail hedge funds are regulated within the same framework as other publicly offered investment funds.

The Retail Hedge Fund Market Is Larger Than the High Net Worth Market

With $27.9 billion of hedge fund assets managed on behalf of institutional and individual investors in December 2004, Canada represents approximately 2 per cent of the global hedge fund market.

Hedge fund assets held by individual investors in Canada grew at an impressive compound annual rate of 43 per cent over the five years to December 2004. At that date, high net worth investors held $6.6 billion in the form of stand-alone hedge funds[3] and funds of hedge funds[4] while retail investors held $8.8 billion in the form of principal-protected products such as principal-protected notes[5]. Although these figures must be used with caution, they indicate that the retail market for hedge funds in Canada is larger than the high net worth market.

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[2] UCITS stands for "Undertakings for Collective Investment in Transferable Securities".
[3] Stand-alone hedge funds are usually advised by a single adviser according to a single investment strategy.
[4] Funds of hedge funds invest in securities of stand-alone hedge funds and are diversified by adviser and strategy. A variant of the fund of hedge funds is the multi-adviser fund. Here, instead of being invested in stand-alone funds, the assets of the fund are allocated to a number of advisers, each of which manages its account using a different investment strategy. A multi-adviser fund is just as effective as a fund of hedge funds in providing diversification.

Macro Issues

Systemic Risk

The counterparties of hedge funds are mostly banks. For practical reasons, most jurisdictions manage the systemic risk posed by hedge funds in an indirect manner through their supervision of banks, in particular by ensuring that the latter have implemented proper risk management systems.

The systemic risk posed by hedge funds in Canada is small because Canadian banks have implemented effective risk management practices as regards their hedge fund exposure. Also, given the small size of the Canadian hedge fund industry, the exposure of banks to Canadian hedge funds is low.

The maintenance of effective risk management practices is a never-ending process. Certain observers have pointed out that a bank may be tempted to relax its discipline in order to gain, or simply to maintain, market share. This indicates the necessity for continued assessment by banks of their hedge fund exposure and continued vigilance on the part of the regulatory authorities.

Going forward, the Basel II framework provides for the differentiation of capital requirements on the basis of risk. As Basel II is implemented in the next few years, it will be possible to relate more effectively the regulatory capital of banks to their hedge fund exposure.

In addition to their direct exposure, Canadian banks face indirect exposure to hedge funds. If a major non-Canadian hedge fund were to fail, dragging one or more non-Canadian banks in its wake, this might have an indirect impact on Canadian banks with exposure to these non-Canadian banks. We would encourage Canadian regulators to continue exchanging information on the systemic risk posed by hedge funds with their foreign counterparts both on a bilateral basis and on multilateral fora such as the Financial Stability Forum.

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[5] In this report, principal-protected notes refer to notes usually issued by banks or Crown corporations, whose principal is guaranteed and whose return is linked to that of a hedge fund or fund of hedge funds.

Risks of Principal-Protected Notes to the Reputation of Canada's Credit

Crown corporations are among the issuers of principal-protected notes aimed at retail investors. This raises issues of public policy and reputational risk. Among the concerns is the potential impact on the reputation of Canada's credit if the investors ultimately receive no return on their investment.

A recent report prepared for the Department of Finance recommends that guidelines should be established as to the types of structured notes that are appropriate for Crown corporations, the manner of reporting the risk-adjusted cost of capital, and the minimum risk management strategies associated with permitted products. We support these recommendations.

Investor Protection Issues

Operational Risks

Hedge funds are subject to a number of operational risks. A major risk relates to the manager's ability to value the fund's assets correctly. Such ability may be hampered by conflicts of interest, lack of resources, lack of incentives to set up an internal control system or, in the case of funds of hedge funds, lack of transparency of the positions held by the underlying funds.

The ultimate operational risk is that of manager failure, of which a number have been witnessed in Canada in the recent past. Failure may be the result of the principals not being fit and proper persons, inadequate capitalisation of the manager, or the lack of internal controls.

Form over Substance

Principal-protected notes are distributed under an exemption that applies to the debt instruments of certain entities. Although principal-protected notes usually take the form of a debt instrument of a bank or a Crown corporation, in substance they are hedge funds because their return is linked to that of an underlying fund of hedge funds, net of fees and expenses. They are thus regulated according to their form (i.e., a debt instrument of a bank or a Crown corporation) and not their substance (i.e., a hedge fund).

In order to protect retail investors, publicly offered mutual funds are subject to strong regulatory safeguards relating to simplified prospectus and continuous disclosure, operational and sales practices, and the management of conflicts of interest. Investors in principal-protected notes enjoy none of these regulatory protections because the underlying fund is privately distributed and the wrapper is treated as an exempt debt instrument.

Other Issues with Principal-Protected Notes

Principal-protected notes normally include a mechanism or structure to reduce the risk involved in providing the principal guarantee. These structures are set up by the guarantor and are meant for its protection and not that of the investor. It would seem that many investors do not understand this. In the course of our research, we found that many persons were under the impression that these structures enhanced investors' protection. In actual fact, investors are totally dependent on the creditworthiness of the guarantor. In the worst-case scenario, which is the bankruptcy of the guarantor, note holders will rank as unsecured creditors and will not have preferential access to the investments held in the structure.

Principal-protected notes have long maturities. Since the risk of loss on a portfolio decreases with time, the principal protection offered by principal-protected notes is arguably not necessary, except for conservative investors.

Principal-protected notes are expensive. It would not be unusual for more than half of the gross return to be consumed by fees and expenses.

The contents of disclosure documents are not prescribed and the quality of disclosure varies. It is doubtful whether investors understand the full cost of owning the investment. There are questions as to whether intermediaries pay adequate regard to the suitability requirement. [6]

Impact of Inadequate Disclosure on the Level of Intermediaries' Remuneration

Some industry observers have pointed out to us that there is a direct causal link between the lack of a requirement to disclose the remuneration of intermediaries that distribute principal-protected

[6] We use the term "intermediary" to refer to investment and mutual fund dealers and their representatives as well as other persons performing a similar function.

notes and the level of such remuneration. We believe that managers would be more restrained in their use of intermediaries' remuneration as a competitive tool if they were required to disclose such remuneration clearly and explicitly in the information statement.

What Need for Regulation?

Except for the prospectus-based regime and for the instrument on commodity pools, there is at present no regulatory framework in Canada for retail hedge funds. We believe that this situation is less than ideal. First, it has prevented retail investors from having direct, efficient access to legitimate investment strategies that can improve the risk-return trade-off of their portfolio. Secondly, it has allowed principal-protected notes to become the mainstream retail hedge fund vehicle when their proper role should be that of a specialty product for a limited market segment.

Indirect Access to Hedge Funds Is Inefficient and Costly

We may analogize principal-protected notes with the RRSP clone funds which existed prior to the abolition of the foreign-property rule. Clone funds were devised to enable registered investment accounts to do indirectly what they could not do directly, i.e., gain unlimited exposure to foreign markets. Because of the additional costs involved, clone funds were always recognized as an inefficient vehicle. When the foreign-property rule was abolished in 2005, clone funds became redundant because their inefficiency could no longer be justified.

Similarly, principal-protected notes were devised to enable retail investors to gain indirect exposure to hedge fund strategies. Here, the obstacle was not a rule. Rather, it was an absence of rules. The lack of a regulatory regime for retail hedge funds made it impossible to offer hedge funds directly to retail investors.

Nature abhors a vacuum. It is a characteristic of a dynamic, innovative capital market that it will move quickly to seize a perceived opportunity. In this case, the solution that the market devised was to wrap a debt instrument of a bank or a Crown corporation around a fund of hedge funds and take advantage of an exemption provided by securities legislation to distribute the product widely.

The solution is to remove the obstacle that gave rise to the inefficient product. In this case, this means putting in place appropriate protections in the form of a regulatory framework for retail hedge funds that would allow retail investors to buy hedge funds directly. We have been told by managers of principal-protected notes that, if they could offer hedge funds directly to retail investors, they would do so rather than go the indirect route.

We believe that markets should be allowed to function as freely as possible and that there should be regulatory intervention only when this is clearly necessary and when the benefits of regulation outweigh the costs. It seems to us that this is one of those cases where regulatory intervention is warranted. A number of jurisdictions outside of North America have already crossed that bridge.

How a Specialty Product Became a Mainstream Product

Structured products play a useful role because they meet the needs of conservative investors who want principal protection and are willing to pay for it. If a retail investor wishes to buy, say, an index fund, this can be done directly. If the investor is conservative and wants protection against the loss of principal, he can buy a structured product offering the same index fund with a principal protection. In exchange for the principal protection, the investor will incur higher costs and enjoy less regulatory protection. It will be open to the investor to weigh the pros and cons and decide which investment is better in the circumstances.

A retail investor who wishes to buy a hedge fund cannot do so directly. The best the investor can do is to invest indirectly through a principal-protected note. It is this absence of choice that has allowed principal-protected notes to become the mainstream retail hedge fund vehicle when their proper role should be that of a specialty product for conservative investors.

Benefits of a Regulatory Framework

Regulation implies costs but it also brings benefits. By gaining direct, efficient access to absolute return strategies, retail investors will be able to improve the efficiency of their investment portfolio while at the same time benefiting from cost savings.

A strong but appropriate regulatory framework has legitimized mutual funds as an investment vehicle and created the necessary sense of security for investors to trust the product. It could do the same for the hedge fund industry.

A Canadian Framework

Retail Investors Should Have Access to Funds of Hedge Funds Only

Unlike a mutual fund, a stand-alone hedge fund is not a diversified portfolio in itself. An investment in a stand-alone hedge fund is effectively an investment in an adviser's skill at applying a given investment strategy. When investing in a stand-alone hedge fund, there is a real risk that the investor may lose all his or her money. In order to achieve diversification with hedge funds, it is necessary to use funds of hedge funds.

We recommend that retail investors should have access only to funds of hedge funds (including multi-adviser funds) but not to stand-alone hedge funds. Given the relative safety of funds of hedge funds, we recommend that there should not be a minimum purchase amount.

It goes without saying that the opening of retail markets to funds of hedge funds should be accompanied by initiatives to educate the investor on the subject of alternative investing. Regulatory authorities and industry associations can play a useful role in this regard. We believe that investor education on this subject should emphasize the benefits of diversification, the differences between traditional and alternative investing, and the way in which funds of hedge funds may contribute to improve a portfolio's diversification.

A Structural Approach

In line with IOSCO's recommendation, we believe that a regulatory framework for retail hedge funds is best integrated within the existing mutual fund framework. The existing National Instrument 81-104 *Commodity Pools* ("NI 81-104") constitutes an embryonic hedge fund framework. A possible way to implement our recommendations would be to update and modernise NI 81-104 to enable retail investors to invest in funds of hedge funds while benefiting from the protection of regulatory oversight.

Retail hedge funds would be subject to all the regulations generally applicable to mutual funds with appropriate adjustments to take account of the particularities of hedge funds.

NI 81-102 prohibits a fund of funds from holding securities of an underlying fund unless both funds are qualified for distribution in the local jurisdiction. A carve-out from this prohibition would be required to enable retail funds of hedge funds to invest in underlying unregistered hedge funds.

While calculating performance fees charged to retail funds of hedge funds, high-water marks should be made mandatory. In addition, performance fees should be computed on the basis of the performance of the fund of funds as a whole and not that of each underlying fund.

Hedge fund managers sometimes pay a portion of their performance fees to intermediaries in the form of trailer fees. Existing mutual fund regulations would not allow this. These regulations have been extremely successful at reducing, if not eliminating, conflicts of interest between intermediaries and their clients. We see no compelling reason for recommending a change to the regulations.

NI 81-104 already allows a lock-up period of up to six months. It also allows the payment of the redemption price within 15 days after the date of calculation of the redemption price, as opposed to three business days for regular mutual funds. It would be useful for the regulations to also specify a minimum frequency for redemptions, say, at least once every month or quarter, and a maximum notice period.

Given the concerns on valuation, we recommend that the fund's assets should be valued not by the fund manager but by an independent third party. This could be the fund's administrator. We also note that the financial statements of the fund will be audited, thus providing another layer of comfort.

It is important for funds of funds not to rely exclusively on the valuations provided by the managers of the underlying funds. Retail funds of hedge funds should be required to institute procedures to satisfy themselves independently that the underlying hedge funds are fairly valued.

Certain hedge funds enter into side letters with certain investors who thereby benefit from additional rights such as lower fees, the right to be notified on the occurrence of certain events, and preferential redemption rights. All investors of the same class should be treated in the same way. Side letters give rise to concerns because they may result in investors of the same class not being treated equally. The disclosure of information to some investors but not to others is also a cause for concern. We recommend that retail hedge funds should be prohibited from entering into side letter agreements.

There are certain features peculiar to hedge funds that should be required to be disclosed by a retail hedge fund regime. These include all fees and compensation of the manager and the intermediary, including the method of computation and the disclosure of the layers of fees and expenses involved in funds of funds, and all conflicts of interest.

The managers of retail hedge funds and other investment funds should be encouraged to experiment with outcome-based disclosure. Outcome-based disclosure focuses on the range of possible outcomes of an investment in a form understandable by the retail investor. We believe that outcome-based disclosure should be supplementary to, rather than a substitute for, traditional forms of disclosure.

The Regulation of Principal-Protected Notes

If retail investors are allowed to purchase hedge funds directly, we expect that principal-protected notes will become a specialty product for those investors who want principal protection and are willing to bear the costs. In order to provide appropriate protection to these investors, we recommend that principal-protected notes linked to hedge funds should be subject to the same regulatory requirements, particularly as regards disclosure and sales practices, as retail hedge funds. In other words, they should be regulated according to substance rather than form. We believe that this recommendation properly addresses the cause rather than the symptoms of the problem.

Qualifications of the Manager

Hedge funds are subject to a number of operational risks, including incorrect valuation of the fund's assets and manager failure, which is the ultimate operational risk. Manager failure may cause hardship to the investors concerned and may erode confidence in the system. It would not be in Canada's interest if investors stopped investing in investment funds.

We believe that the most appropriate way to manage the operational risks to which hedge funds are subject is through registration of the manager. Our recommendations on the conditions of manager registration stem from the issues we have identified in this report and are not intended to be comprehensive.

It should be noted that the objective is not to prevent manager failure at all costs. Rather, the objective is to put in place a system to identify problems in a timely manner so as to enable appropriate regulatory action to be taken before it is too late.

The point is sometimes made that hedge funds and private equity funds are converging. We believe that the scope for convergence is limited for two main reasons. First, the balance sheet of a hedge fund does not lend itself to significant private equity investments. Secondly, private equity investing requires business management and operational skills that are not required in hedge fund investing.

Private equity and venture capital funds do not give rise to the same concerns as hedge funds. In particular, the very long-term nature of the investment limits the extent of retailisation. Consequently, we do not recommend that the registration requirements should be extended to the managers of private equity and venture capital funds.

We expect that the registration of a hedge fund manager will be dependent upon its being able to demonstrate a strong organizational structure, including the assignment of responsibility for the key areas of investment, risk management, finance, and compliance to specific individuals with appropriate experience and proficiency.

We would also expect the manager to demonstrate that it has set up and documented a proper internal control system, a risk management policy, and an appropriate due diligence process.

Given that fund pricing errors may be fatal to a manager, we recommend that Errors and Omissions coverage be made mandatory. The deductible should be added to the required capital.

We believe that capital and insurance requirements should be related to the business model of a fund manager, its needs for cash, and the risks involved. In this light, we recommend that fund managers be required to have minimum capital amounting to expenses of a certain number of months, say three or six months, together with a fixed amount to serve as a cushion. The exact number of months will depend on the frequency with which the regulatory authorities intend to review the financial statements of the registrants. To provide some context for the interpretation of the financial statements, the filings should also include operational data such as gross sales, redemptions, net sales, and average and closing assets under management. Any unusual trends such as a very rapid growth in assets under management or very heavy redemptions would raise red flags.

The point is sometimes made that minimum capital requirements constitute a barrier to entry. Our experience is that the venture capital industry in Canada is dynamic enough that new entrants with a proper track record and a solid business plan should find it possible to raise the requisite capital.

We recommend that new entrants to the industry should be required to submit a business plan showing, among other things, the cash needs of the business for the foreseeable future together with the available sources of cash.

As an additional protection for investors, consideration should be given to requiring the manager to have a minimum level of hedge fund assets under management prior to launching retail hedge funds.

Qualifications of the Adviser

It would be prudent to follow the example of other jurisdictions in requiring the adviser to have employees with a certain number of years' experience in applying hedge fund strategies, including specific experience of funds of hedge funds.

The Intermediary and the Selling Process

Intermediaries are responsible for ensuring the suitability of all investments that they sell to a client. This is as it should be. It is in the implementation of the suitability requirement by intermediaries and its enforcement by regulators that improvements are required.

In order to implement properly the suitability requirement, intermediaries must have knowledge both of the client and the product. Knowledge of the client is enshrined in the "Know-Your-Client" or "KYC" rule that is well understood throughout the industry. Knowledge of the product is a requirement that is less understood. In this context, the Mutual Fund Dealers Association ("MFDA") is to be commended for the recent issue of a regulation notice entitled "Know-Your-Product" ("KYP").

Enforcement

Proper enforcement of the retail hedge fund regulatory framework requires an understanding of the industry. We believe it would be beneficial for the securities commissions to set up a centre of hedge fund expertise along the lines of the FSA. To avoid duplication, the centre could be a unit of the Canadian Securities Administrators ("CSA"). In addition to the management of relationships with participants in the hedge fund industry and the thematic supervision of managers, we envisage that the centre will assist in the development of regulatory policy for the industry and provide advice to the various departments of the securities commissions on all hedge fund matters.

Risk assessment models may be used to assess the relative riskiness of fund managers. These models can be useful in deciding which firms to inspect and what matters to inspect in detail, but they are not easy to construct.

Research has identified a number of fraud predictors. These can be applied with relative ease and we believe that their use within regulators' risk assessment models can enhance the identification of potential problems ahead of time. Predictors of fraud include opportunity factors, motivational factors, and management attitudes. Some of these fraud predictors were present in the cases of manager failure that have recently occurred in Canada.

Key Recommendations

We summarize our key recommendations below:

Recommendation #1: To manage systemic risk, Canadian regulatory authorities should show continued vigilance in ensuring that banks are continuously assessing their hedge fund exposure(Section 6 (i)).

Recommendation #2: To keep track of the indirect exposure of Canadian banks to hedge funds, Canadian regulators should continue exchanging information with their foreign counterparts both on a bilateral basis and on multilateral fora such as the Financial Stability Forum (Section 6(i)).

Recommendation #3: If the current borrowing framework for Crown corporations is maintained, guidelines should be established as to the types of structured note that are appropriate for Crown corporations (Section 6(ii)).

Recommendation #4: Retail investors should be allowed to invest directly in funds of hedge funds, including multi-adviser funds (Section 8(ii)).

Recommendation #5: Retail investors should not have access to stand-alone hedge funds (Section 8(ii)).

Recommendation #6: Purchases of retail funds of hedge funds should not be subject to a minimum purchase amount (Section 8(ii)).

Recommendation #7: The opening of retail markets to funds of hedge funds should be accompanied by initiatives to educate the investor on the subject of alternative investing (Section 8(ii)).

Recommendation #8: The regulatory framework for retail funds of hedge funds should be integrated within the existing mutual fund framework. A possible way to implement our

recommendations would be to update and modernise the existing National Instrument 81-104 *Commodity Pools* (Section 8(iv)).

Recommendation #9: Retail funds of hedge funds should be allowed to invest in underlying unregistered hedge funds (Section 8(iv)(c)).

Recommendation #10: Performance fees of retail funds of hedge funds should be subject to mandatory high-water marks, and be computed on the basis of the performance of the fund of funds as a whole and not that of each underlying fund (Section 8(iv)(d)).

Recommendation #11: Managers of retail funds of hedge funds should not be allowed to pay a portion of their performance fees to intermediaries in the form of trailer fees (Section 8(iv)(e)).

Recommendation #12: The regulations should specify a maximum lock-up period, a minimum frequency for redemptions, and a maximum notice period (Section 8(iv)(f)).

Recommendation #13: The assets of retail funds should be valued not by the fund manager but by an independent third party such as the fund's administrator (Section 8(iv)(g)).

Recommendation #14: Retail funds of hedge funds should be required to institute procedures to satisfy themselves independently that the underlying hedge funds are fairly valued (Section 8(iv)(g)).

Recommendation #15: Retail funds of hedge funds should be prohibited from entering into side-letter arrangements (Section 8(iv)(h)).

Recommendation #16: Retail funds of hedge funds should be required to make full disclosure of all fees and compensation of the manager and the intermediary, and all conflicts of interest (Section 8(iv)(h)).

<u>Recommendation #17</u>: Investment fund managers should be encouraged to experiment with outcome-based disclosure. This should be supplementary to, rather than a substitute for, traditional forms of disclosure (Section 8(iv)(i)).

<u>Recommendation #18</u>: Principal-protected notes linked to hedge funds should be subject to the same regulatory requirements, particularly as regards disclosure and sales practices, as retail hedge funds (Section 8(iv)(j)).

<u>Recommendation #19</u>: Hedge fund managers should be required to register (Section 8(v)).

<u>Recommendation #20</u>: There is no need to extend the registration requirement to managers of private equity and venture capital funds (Section 8(v)(a)).

<u>Recommendation #21</u>: Errors and Omissions coverage should be mandatory for fund managers. The minimum regulatory capital should include the amount of any deductible (Section 8(v)(c)).

<u>Recommendation #22</u>: Fund managers should be required to have minimum capital amounting to expenses of a certain number of months together with a fixed amount to serve as a cushion (Section 8(v)(d)).

<u>Recommendation #23</u>: To provide some context for the interpretation of the manager's financial statements, the financial statement filings should also include operational data such as gross sales, redemptions, net sales and average, and closing assets under management (Section 8(v)(d)).

<u>Recommendation #24</u>: New fund managers should be required to submit a business plan as a condition of registration (Section 8(v)(d).

<u>Recommendation #25</u>: Consideration should be given to requiring managers of retail funds of hedge funds to have a minimum level of hedge fund assets under management prior to launching retail funds (Section 8(v)(e)).

Recommendation #26: The employees of the adviser of a retail fund of hedge funds should have a certain number of years' experience in applying hedge fund strategies, including specific experience of funds of hedge funds (Section 8(vi)).

Recommendation #27: The implementation of the suitability requirement should be improved through greater emphasis on knowledge of the product on the part of intermediaries and more stringent enforcement by regulators (Section 8(vii)).

Recommendation #28: A centre of hedge fund expertise should be set up. To avoid duplication, the centre could be a unit of the CSA (Section 8(viii)).

Recommendation #29: Fraud predictors should be incorporated within regulators' risk assessment models to help identify potential problems ahead of time and decide which firms to inspect and what matters to inspect in detail (Section 8(viii)).

2. Mandate

Our mandate was to assist the Task Force to Modernize Securities Legislation in Canada ("Task Force") by making recommendations on a Canadian framework for hedge fund regulation. In formulating our recommendations, we were to strike an appropriate balance among various needs: the protection of investors, appropriate access by investors to hedge fund strategies, and the encouragement of product innovation in capital markets.

The Task Force was set up by the Investment Dealers Association of Canada ("IDA") in June 2005 to examine issues related to investor protection, access to capital, enforcement, governance, and regulatory burden, while drawing on the latest regulatory thinking in Canada and abroad.

In the area of hedge funds, the Task Force was directed to examine the issues described in the recent IDA report.[7]

i. Previous Canadian Studies

In fulfilling our mandate, we benefited from a number of previous Canadian studies on the regulation of hedge funds and similar investment vehicles. We benefited particularly from the IDA report mentioned above and from the report of the Task Force on Debt-Like Derivatives.[8]

a) IDA Report

The primary purpose of the IDA report was to examine hedge fund activities in Canada and the involvement of IDA member firms or their affiliates in such activities. The IDA observed that hedge funds, including related products directed at the retail market such as principal-protected notes, are exempt from most regulatory requirements such as the filing of a prospectus and the involvement of a registered dealer. However, these products fall within the ambit of IDA regulations as to suitability. The IDA noted that, when pursuing due diligence on hedge fund products, dealers have to contend with the risks resulting from conflicts of interest, complex fee structures, lack of disclosure requirements, lack of controls on pricing and valuation, and all the other problems stemming from the lack of direct regulation of highly complex products.

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[7] Investment Dealers Association of Canada, Regulatory Analysis of Hedge Funds, May 18, 2005.
[8] Report of the Task Force on Debt-Like Derivatives, January 5, 1999.

Besides internal recommendations to be dealt with by the IDA itself, the report recommended a review of provincial laws, regulations and approaches and, if necessary, the development of amendments to bring hedge fund products offered to the retail investor fully within the regulatory system.

b) Report of the Task Force on Debt-Like Derivatives

The Task Force on Debt-Like Derivatives ("Derivatives Task Force") was set up by the Ontario Securities Commission ("OSC") with a mandate to review the application of the existing securities regulatory regime in Ontario to the distribution of debt-like derivative securities and make recommendations on the regulation of debt-like derivatives at the retail level. Broadly speaking, a debt-like derivative is a financial instrument in the form of debt and where the interest (and, in some cases, repayment of part of the principal) is linked to the performance of an equity index or other underlying interest.

The Derivatives Task Force took the position that it would be reasonable for investors to expect a level playing field and the same minimum standard of disclosure in connection with debt-like derivative instruments, whether the instrument is properly characterized as a security, a deposit, an insurance contract, or otherwise. In other words, substance should prevail over legal form.

The Derivatives Task Force also took the position that debt-like derivatives should be regulated according to the same "disclosure-based" approach as conventional securities, as opposed to a "merit-based" approach. In other words, the role of the regulator should be to ensure that all relevant facts about the debt-like derivative have been disclosed to the investor. Its role should not be to pass judgement on the merits of the investment, this being the prerogative of the investor.

The Derivatives Task Force recommended that the prospectus and dealer registration exemptions in the Securities Act (Ontario) should not be available to debt-like derivatives. It then made a distinction between two types of debt-like derivatives. Debt-like derivatives which met certain conditions would be qualified to use an "alternative disclosure regime", in which case they would not have to comply with the prospectus and registration requirements. It was intended that the alternative disclosure regime would include a simple term sheet describing, among other things, the economic terms and risks of the instrument and a generic form of risk disclosure statement.

Debt-like derivatives would be qualified to use the alternative disclosure regime if the initial purchase price was not at risk, all amounts payable were due no later than 10 years after issuance, and the amounts payable were based on underlying interests that were widely known and not subject to manipulation by the issuer of the instrument.

Debt-like derivatives not meeting these conditions would need to comply with the prospectus and registration requirements of the Securities Act (Ontario).

ii. IOSCO Reports

We also benefited from reports of the Technical Committee of IOSCO.

a) Regulatory and Investor Protection Issues

In 2003, the Technical Committee of IOSCO issued a report on regulatory and investor protection issues arising from the participation of retail investors in hedge funds.[9] IOSCO took the view that, given the diversity of hedge funds, hedge funds as a group are no riskier than certain “normal” sector funds, e.g., funds investing in the information technology sector. Indeed, IOSCO made the point that the inclusion of hedge fund techniques may in fact produce a more predictable return for a portfolio.

IOSCO recognized that it was up to individual regulators to decide whether or not hedge funds should be sold to retail investors in their respective markets. However, when a jurisdiction decides to allow hedge funds to be marketed to the retail public, it is not necessary, from an investor protection viewpoint, to develop new approaches. Instead, the same principles that are embodied in the regulation of mutual funds are relevant for the regulation of hedge funds.

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[9] Technical Committee of the International Organization of Securities Commissions, Regulatory and Investor Protection Issues Arising from the Participation by Retail Investors in (Funds-of) Hedge Funds, February 2003.

b) Approaches to Hedge Fund Regulation

In March 2006, the Technical Committee of IOSCO released a draft report summarising the results of a survey among 20 jurisdictions on their approaches to hedge fund regulation.[10] The draft report emphasized that investor protection principles for hedge funds should focus on the following needs:

- Ensuring that there is clear, concise, and effective disclosure of the features of the hedge fund. This might include fees, risks, the experience of the fund managers, internal controls, performance disclosures, conflicts of interest, fund of hedge fund issues, etc.
- Developing principles around valuation issues.

iii. Hedge Fund Roundtable

We also benefited from the insights provided by the participants at a roundtable held by the Task Force at the Rotman School of Management, University of Toronto on February 1, 2006. The participants comprised a representative cross-section of industry participants, including hedge fund managers and advisers, prime brokers and administrators, intermediaries, regulators, representatives of institutional and individual investors, securities lawyers, and academics.

3. Hedge Funds and Efficient Portfolios

Hedge funds are investment pools that aim at generating absolute, positive returns in all market conditions while at the same time protecting capital. Hedge funds are sometimes characterized as privately distributed. We believe that this characterization is now less appropriate because hedge fund strategies are becoming increasingly available to a broader investing public.

Hedge funds share certain characteristics. They have broad investment mandates and use techniques such as leverage and short selling. Hedge funds often feature lock-up periods during which the securities may not be redeemed by investors. At the end of the lock-up period, there are limited redemption opportunities.

[10] Technical Committee of the International Organization of Securities Commissions, The Regulatory Environment for Hedge Funds: A Survey and Comparison (Consultation Report), March 2006.

The hedge fund manager generally invests its own money in the fund alongside other investors, thereby aligning its interests with those of outside investors. The manager's compensation normally includes a share of the investment returns in the form of performance fees.

Hedge funds are sometimes described as alternative investments in opposition to traditional investments such as stocks and bonds.

i. Traditional Investing Is Focused on a Benchmark Index

Funds which invest in traditional asset classes such as stocks and bonds may be managed actively or passively. When a fund is managed passively, it seeks to replicate the performance of an index such as the S&P/TSX Composite Index. The adviser will try to achieve this by holding stocks in the fund in the same proportion as in the index.

In the case of an actively managed fund, success is usually measured by the fund's ability to perform better than a benchmark index.

The adviser may attempt to outperform the index by holding stocks in different proportions from the index. It will overweigh, that is hold more of, those stocks that it believes to be under priced by the market. At the same time, it will under weigh or altogether avoid those that it believes to be overpriced. An adviser with strong convictions may hold stocks in very different proportions indeed from the benchmark index. The expectation is that the mispriced stocks will, in due course, gravitate to their fair price.

Mispriced stocks may be identified by using fundamental or technical analysis. Simply stated, fundamental analysis aims at assessing the worth of a stock by analyzing its operational and financial performance, whereas technical analysis attempts to predict the future price of a stock by analyzing the trend of past prices and the volume of shares traded on the markets. If the adviser has correctly picked the mispriced stocks, the fund will indeed outperform the benchmark index.

Another technique used to beat the benchmark index is market timing.[11] The adviser will attempt to boost its returns by judicious timing of its purchases and sales of stocks. It will buy a stock when it believes that the stock price has reached a trough and sell when it believes that the price has reached a peak.

The return of a traditional portfolio is heavily influenced by the return of the benchmark index it is tracking. When the benchmark is experiencing negative returns, it would be usual for a traditional portfolio to do the same. Nevertheless, the adviser will be deemed to have been successful if the portfolio's losses are lower than those of the benchmark.

ii. Hedge Fund Performance Depends on the Adviser's Skill, Not on Market Conditions

In contrast to traditional advisers whose performance is judged *relative* to that of a benchmark, or sometimes relative to that of their peers, hedge fund advisers actively manage their funds by using investment strategies whose outcome does not depend on market conditions. This is why hedge fund returns are said to be *absolute*. The return of a hedge fund depends on the adviser's skill in applying a given investment strategy, not on the conditions of the stock and bond markets.

iii) Hedge Funds Employ Techniques Not Used by Traditional Advisers

Hedge funds are able to generate returns that are independent of market conditions through the use of two financial techniques that are usually off limits to traditional fund advisers: short selling and leverage.

a) Short Selling

Short selling involves selling a stock that one does not own in anticipation of a drop in its price. Since the buyer will expect delivery of the stock, the short seller needs to borrow the stock from a broker. If indeed the price does fall, the hedge fund will buy the stock at the lower price, thereby

[11] This is not to be confused with the "market timing" practices involved in the 2004 regulatory probe into mutual fund trading practices. Those practices took advantage of stale prices used in the pricing of certain mutual funds. Stale prices can arise from differences in exchange closing times.

making a profit, and return the borrowed stock to the broker. Buying back a stock that one has previously sold short is known as covering one's position.

On the other hand, if the hedge fund judged wrongly and the stock price instead rises, the hedge fund will lose money because it will need to purchase the stock at a price higher than what it obtained on the original short sale. The loss from a short position is theoretically infinite since there is no limit on the extent to which a stock price may rise.

A short position can be particularly costly during a short squeeze. A squeeze occurs when a stock has been shorted by so many investors that there are not enough shares to be borrowed. As these investors all try to cover their positions by buying shares on the market, they put upward pressure on the stock price.

The ability to take short positions is fundamentally important to hedge funds. This is what enables hedge funds to profit from overvalued stocks. Contrast this with traditional advisers who are only able to take long positions. These advisers can do little about overvalued stocks except underweigh or avoid them.

Discussions of short selling normally emphasize its risky nature. However, short selling can actually reduce the risk of a portfolio. A long-only portfolio is fully exposed to the risk of a market downturn. Short selling can reduce this market exposure. This is illustrated in Appendix 1, where we describe a number of hedge fund strategies. The use of short selling is integral to the pursuit of absolute returns.

The term "hedge fund" is actually derived from the concept, developed by Alfred Winslow Jones, of offsetting long positions with short positions in order to protect, or hedge, against market risk. Jones is credited with having established the first hedge fund in the United States in 1949.

b) Leverage

In a hedge fund context, leverage means increasing the fund's investment exposure without increasing the amounts invested by the fund's investors. The traditional way to implement leverage is through borrowing.[12] The proceeds from borrowing are used to buy additional investments, thereby increasing the fund's exposure.

Leverage magnifies profits and losses. If the return on the additional investments is higher than the interest rate on the borrowing, this will increase the profits for the fund's investors. The reverse will be true if the return is lower than the interest rate.

Leverage is not used solely to enhance returns. There are some hedge fund strategies that are impossible to implement without creating a liability. In these cases, leverage is not a return enhancer but an essential tool to implement the investment strategy.[13]

Leverage and Derivatives

In addition to outright borrowing, leverage may be achieved through the use of derivatives. These are financial instruments whose value is derived from that of an underlying asset. An example of a derivative is an option. A certain type of option, known as an American-style call option, gives the holder the right to buy a certain stock at a given or determinable price, called the exercise price, within a predetermined period known as the "term". If the market price of the stock rises above the exercise price, the holder will exercise the option and buy the stock at the exercise price. He can then sell the stock on the market at the higher market price and make a profit. If the market price of the stock stays stubbornly below the exercise price throughout the term, the option will expire worthless and the holder will have incurred a loss equal to the purchase cost of the option.

The price of the option will be lower than that of the stock. By buying the option, it is therefore possible to gain more exposure to the stock than by buying the stock itself.

Of course, the use of derivatives is in no way limited to the implementation of leverage. In particular, derivatives may also be used to reduce risk.

[12] This includes borrowing on margin.
[13] Sanford J. Grossman, "Hedge Funds Today: Talent Required", *Wall Street Journal*, September 29, 2005.

iv. Hedge Fund Strategies Vary in Their Degree of Risk

There are definite advantages, notably in terms of ease of communication, in using a standard classification of hedge fund strategies. We have therefore adopted the classification used by the Alternative Investment Management Association ("AIMA"), which is a variant of a scheme originally designed by the hedge fund data supplier CSFB/Tremont.[14]

Table 1 below shows the main hedge fund strategies. These may be classified into three categories: relative value, event-driven, and opportunistic.

Arbitrage

It will be apparent from Table 1 that most relative-value strategies involve the use of arbitrage. Arbitrage is an investment strategy that can be used profitably whenever there are price discrepancies between two related securities. Suppose a stock is inter-listed on the Toronto Stock Exchange and the New York Stock Exchange. Its price on the two exchanges should be the same after taking the exchange rate and transaction costs into account. Whenever this is not the case, it is possible to make a profit by simultaneously buying the stock on the exchange where it is cheaper and selling it where it is more expensive.

Arbitrage is a way to exploit market inefficiencies. Typically, these inefficiencies are small. In order to enhance the return from arbitrage strategies, hedge funds often use leverage.

[14] Alternative Investment Management Association (Canadian chapter), AIMA Canada Hedge Fund Primer, 2004.

Table 1
Classification of Hedge Fund Strategies

1. Relative Value

- Convertible Arbitrage
- Fixed-income Arbitrage
- Equity Market-Neutral

2. Event-Driven

- Merger Arbitrage
- Distressed Securities/High-Yield Securities

3. Opportunistic

- Equity Hedge (Long/Short)
- Global Macro
- Managed Futures
- Emerging Markets

Source: AIMA Canada

Hedge fund strategies vary in terms of investment risk. Table 1 generally lists the investment strategies in ascending order of risk. The arbitrage strategies at the top of the table are among the least risky. Arguably, some arbitrage strategies are no riskier than some traditional investing strategies involving equities. Sector mutual funds such as those investing in technology stocks come to mind. The relatively low risk of arbitrage strategies is the reason why hedge funds using these strategies can afford to be leveraged.

The opportunistic strategies at the bottom of Table 1 are generally the riskiest.

v. How Hedge Funds Make or Lose Money

We have attempted to demystify hedge funds by providing in Appendix 1 some insights into a number of investment strategies from all three categories. We discuss:

- convertible arbitrage;
- merger arbitrage;

- distressed securities; and
- long/short equity.

Observe in each case how the hedge fund's performance depends on the adviser's skill, for instance, at picking the right stocks. Observe also how the hedge fund is able to generate a positive return even if the overall market is down.

Appendix 1 also explains the risks involved in each strategy and how they may cause the fund to incur losses.

Investable Indices and Passive Hedge Fund Investing

As explained earlier, passive investing is about replicating the return of an index. There exist a number of hedge fund indices, such as those published by CSFB/Tremont and Hedge Fund Research ("HFR"). Some of these indices include hedge funds that are closed to new investors. It is obviously not possible to invest in such indices. Investable hedge fund indices, which include only hedge funds that are open to new investors, have recently become available. An example is the RBC Hedge 250 Index that was launched by RBC Capital Markets in March 2006 and comprises 250 hedge funds. The availability of investable hedge fund indices has made possible a passive style of hedge fund management.

vi. Investment Risks Specific to Hedge Funds

Hedge funds are subject to certain investment risks over and above those encountered in traditional investing. Hedge funds are exposed to the risks involved in the use of short selling and leverage, as described above. The use of derivatives carries its own risks. Some of the assets in which hedge funds invest may be illiquid or difficult to sell.

In addition, each hedge fund strategy has its own risks. Some of these risks are illustrated in Appendix 1.

Perhaps the greatest risk of all relates to the proficiency of the adviser. As we emphasized earlier, the performance of a hedge fund is crucially dependent on the adviser's skill at applying a given investment strategy.

vii. Benefits of Hedge Funds to Capital Markets

Hedge funds enhance market efficiency. Because hedge funds actively perform research on investment opportunities and their trades reflect the results of this research, securities are better priced than they would otherwise be.

Hedge funds also enhance market liquidity because they trade in large volumes. In addition, hedge funds are sometimes managed with a contrarian approach and are willing to take positions that are the opposite of other market participants.

viii. Hedge Funds Make Investment Portfolios More Efficient

Most investors like high return and low risk. A portfolio that minimizes the risk for a given expected return using a set of available assets is said to be efficient.

Efficient portfolios are constructed through diversification. Diversification is based on a statistical property known as correlation, which measures the relationship between the returns of two assets. The essential point is that the lower the correlation, the more effective the diversification.

Hedge fund returns exhibit low correlations with those of traditional asset classes such as stocks and bonds. This should not be surprising since hedge fund strategies are expressly designed to generate returns that are independent of the markets. By adding hedge funds to a portfolio of traditional assets, it is possible to achieve lower risk for a given expected return. In other words, it is possible to improve the efficiency of the portfolio. This is true of all portfolios, be they those of pension funds, high net worth investors or retail investors.

High net worth investors have long known that hedge funds can improve the trade-off between risk and return. They were among the first to embrace hedge fund investing. In the wake of the bear markets of 2000 to 2002, institutional investors have also taken an interest in absolute return strategies as a way to reduce the volatility of their returns, and their asset allocations increasingly include hedge funds.[15] Retail investors have limited access to hedge fund strategies.

Hedge funds are sometimes viewed as speculative, risky investments from which retail investors in particular must be shielded. We believe that this view overlooks the varied nature of hedge funds and their potential to actually reduce the risk of a portfolio. Our position is in line with that expressed by IOSCO:

> "…there is the notion that hedge funds are inherently risky, and should therefore not be open to non-qualified retail investors. Given the diversity in the kinds of hedge funds, it would probably be unwise generally to conclude that hedge funds as a group are riskier than certain "normal" funds that are specialized (e.g., funds investing in the IT-sector or in private equity). Indeed, the use of hedging techniques may in fact produce a more predictable return."[16]

This is not to say that hedge funds are without problems. We shall investigate hedge fund issues in sections 6 and 7 of this report.

4. A Wealth of International Experience

Canada is part of a global economy and hedge funds are a global industry. Before we address the question of a regulatory framework for hedge funds in Canada, let us review other jurisdictions' experience of hedge fund regulation.

We have selected jurisdictions in each of the three regions with the highest concentration of hedge funds: the United States, the European Union (more particularly, the United Kingdom), and the Asia-Pacific region. It is estimated that approximately 70 per cent of global hedge fund assets

[15] See Eric Tuer and Elizabeth Woodman, "Recent Trends in Canadian Defined-Benefit Pension Sector Investment and Risk Management", *Bank of Canada Review*, Summer 2005, for an account of the adoption of alternative investment strategies by Canadian pension funds.
[16] Technical Committee of the International Organization of Securities Commissions, Regulatory and Investor Protection Issues Arising from the Participation by Retail Investors in (Funds-of) Hedge Funds, February 2003.

are managed in the United States, 20 per cent in Europe, and the rest mostly in the Asia-Pacific region.[17] Canada accounts for approximately 2 per cent of global hedge fund assets.

Most of the jurisdictions concerned have recently conducted or are in the process of conducting a review of their hedge fund regulatory regime.

In the United States, most hedge fund advisers have been required since February 1, 2006 to register with the Securities and Exchange Commission ("SEC").

The European Union and certain member states have made recent changes to their hedge fund regulatory regimes that make it easier for retail investors to access hedge fund strategies. In the United Kingdom, the FSA has recently completed the first phase of a consultation on hedge fund regulation.

Hong Kong and Singapore pioneered the offering of hedge funds to retail investors and have more experience of this aspect of hedge fund regulation than most other jurisdictions.

i. The United States

a) Registration of Hedge Fund Advisers

Prior to February 1, 2006, most hedge fund advisers in the United States were not required to register with the SEC under the Investment Advisers Act of 1940. They were able to avoid registration thanks to a *de minimis* exemption available to advisers who had had fewer than 15 clients during the preceding 12 months, did not hold themselves out generally to the public as an adviser, and were not an adviser to a registered company.[18] A legal organization such as a hedge fund could be counted as a single client. An adviser could thus advise a maximum of 14 hedge funds without being required to register.

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[17] Dan Waters, Asset Management Sector Leader, Financial Services Authority, "Regulation and the Hedge Fund Industry: An Ongoing Dialogue", *Speech at the Hedge Funds Blueprint Europe Conference*, February 8, 2005.
[18] Section 203(b)(3) of the Investment Advisers Act of 1940.

Effective February 1, 2006, hedge fund advisers were required to look through any hedge funds that they managed and count each separate investor as a client.[19] This effectively required most hedge fund advisers to register. The new requirement came in the wake of recommendations in a 2003 staff report to the SEC.[20]

The main concern identified by staff related to the lack of regulatory oversight by the SEC over hedge fund advisers. As a result, the SEC was unable to detect fraud and other misconduct by hedge fund advisers at an early stage. Typically, hedge fund fraud was identified only after the SEC had been contacted by third parties suspecting fraudulent activity. By that time, significant losses had already occurred.

Staff concluded that mandatory registration of hedge fund advisers was the least intrusive form of regulation available to address that concern. Registration subjects an adviser to a number of requirements. For instance, the adviser must disclose certain prescribed information to the SEC and its investors, including informing its clients if its financial condition becomes adverse, submit to examinations by the SEC, maintain required books and records, and safeguard client assets. The SEC expects that the ability to subject advisers to surprise examinations will serve as a deterrent to fraud and other misconduct and foster a culture of compliance.

The new registration requirement does not apply to very small advisers with assets under management of less than US$25 million. It also does not apply to advisers whose funds have a lock-up period of at least two years. The intention was to exclude advisers of private equity and venture capital funds, which typically lock in their investors for the duration of the fund's fixed life. However, this exemption provides a way out for hedge fund advisers who wish to avoid registration. According to the *Wall Street Journal*, many large advisers, including Kingdom Capital Management, Citadel Investment Group, and Eton Park, have imposed longer lock-up periods in order to avoid registration.[21] This rather perverse result is an example of the unintended consequences of regulation.

[19] Rule 203(b)(3)-2 under the Investment Advisers Act of 1940.
[20] Staff Report to the US Securities and Exchange Commission, Implication of the Growth of Hedge Funds, September 2003.
[21] Emma Trincal, "Funds of Funds Could Face Reckoning on Fees", *TheStreet.com*, November 14, 2005. See also Carol E. Curtis, "Registration of Hedge Funds: Headaches Just Beginning", Securities Industry News, February 6, 2006.

b) Valuation of Hedge Funds

Another key concern of SEC staff related to the manner in which hedge fund advisers value hedge fund assets. Advisers have broad discretion on the valuation of fund assets. The concern is heightened because hedge funds invest in highly illiquid securities that are typically difficult to value. In addition, small hedge fund advisers often lack the resources to install adequate pricing systems. Staff also thought that there was an "inherent" conflict of interest because the adviser's performance fee is based on its valuation of the fund assets. The valuation of assets by the adviser is not subject to independent oversight.

c) Registered Funds of Hedge Funds

A number of funds of hedge funds are registered under the Investment Company Act of 1940 and the Securities Act of 1933. This enables them to offer their securities publicly.[22] The number of such funds is currently small but staff noted that there was a potential for the number to increase. The concern was that these companies might not be able to verify independently the valuation of the underlying hedge funds.

The Investment Company Act of 1940 requires the board of directors of registered investment companies to fair value in good faith any securities for which there are no readily available market quotations. This includes investments in underlying hedge funds. Staff made a recommendation designed to improve the operation of this requirement. Staff recommended that registered funds of hedge funds should be prohibited from investing in hedge funds unless their board of directors has instituted *procedures* to ensure that the underlying hedge funds are fairly valued.

Staff also noted that registered funds of hedge funds are required to disclose their own fees and expenses but not those of the underlying hedge funds. To address this concern, staff recommended that all registered investment companies, including registered funds of hedge funds, be required to disclose in a fee table the estimated fees (both asset-based and performance-based) and expenses of the underlying funds.

d) Disclosure

Staff was concerned that, because hedge funds are not subject to any minimum disclosure requirements, investors might not be receiving fundamental information about the adviser and its management of the fund.

In particular, there were concerns that conflicts of interest were not fully disclosed. Two main conflicts of interest were identified. The first relates to the side-by-side management of hedge funds and other client accounts by the same adviser. Because hedge funds pay performance fees and because advisers often invest their own money in their hedge funds, there is a risk that the adviser may favour its hedge fund clients over other clients such as mutual funds. The second conflict of interest relates to the adviser's relationships with prime brokers and the multiplicity of services provided by the latter.

Staff recommended that hedge fund advisers be required to file with the SEC and deliver to investors a disclosure statement tailored to the needs of hedge fund investors.

e) Wider Use of Hedge Fund Strategies in Registered Investment Companies

In the course of the staff investigation, some commentators asserted that retail investors could benefit from greater access to absolute return strategies and hedge fund investment techniques. Staff recommended that the SEC consider issuing a concept release to focus on this issue.

f) Long-Term Impact of Hedge Funds on Issuers

In an otherwise very comprehensive report, staff did not discuss the impact of hedge funds on issuers. Hedge fund activism affects distressed companies as well as underperforming or undervalued issuers. Such activism is beneficial to the extent that it prods the management of the target companies into improving the efficiency of their operations and allocating resources to

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[22] In practice, these registered funds of hedge funds have restricted sales to investors that, as a minimum, satisfy the accredited investor standard. See Staff Report to the US Securities and Exchange Commission, *op.cit,* page 69.

their most productive uses. The concern is that management may feel coerced into taking measures that are beneficial in the short run but not in the long run.

ii. The European Union (EU)

In 1985, the EU issued a directive, known as the UCITS[23] Directive, which provides for a regime of cross-border marketable collective investment schemes. A collective investment scheme is an investment fund. Examples of collective investment schemes are unit trusts and open-end investment companies.[24] The directive sets out the requirements to be observed by UCITS schemes, for instance, investment limits, disclosure requirements, safe-keeping of assets, and fund oversight by an authorized depositary. Once a scheme has been approved by the regulatory authorities in a member state, it can be marketed to retail investors throughout the European Economic area ("EEA") UCITS schemes thus benefit from a passport valid throughout the EEA.

There are currently almost 30,000 UCITS schemes managing €4 trillion of assets or 70 per cent of assets under management in the EEA. UCITS schemes are also widely marketed outside the EEA, namely, in Asia and South America.[25]

The UCITS regime has been recently modernized by the UCITS III directive. The latter became effective in February 2004 and extended the range of assets in which a UCITS scheme may invest. UCITS schemes are now allowed to use derivatives in a manner that achieves the same result as short selling and leverage (up to 100 per cent of the net asset value). Although the UCITS III directive was not intended to enable the development of retail hedge funds, it does allow retail investment funds to use derivatives in a manner that enables them to pursue hedge fund strategies.

Asset managers throughout the EEA are beginning to recognize that the new investment powers given by the UCITS III directive enable them to offer hedge fund strategies to retail investors. In the United Kingdom, a major fund company recently launched an absolute-return product, which

[23] Undertakings for Collective Investment in Transferable Securities
[24] In Canada, these would correspond to mutual funds organized as trusts and corporations respectively.
[25] Commission of the European Communities, Green Paper on the Enhancement of the EU Framework for Investment Funds, July 2005.

will be sold to investors willing to invest either a £10,000 ($20,000) lump sum or £250 ($500) a month.

New Initiatives by the European Commission

In a recent Green Paper, the European Commission noted that hedge funds offer new diversification benefits for asset managers and the promise of higher returns for investors while at the same time being more complex and involving higher risks for investors.[26]

The Commission noted that divergent national regimes carry the risk of regulatory fragmentation that could hamper the development of hedge funds. It intends to establish a working group to study whether a common regulatory approach can facilitate the further development of the European hedge fund market.

Since the development of hedge fund regulation in the EU is influenced by domestic regulations as well as by EU directives, we shall now take a look at home-grown initiatives in a member state, namely the United Kingdom.

a) The United Kingdom

The European hedge fund industry is centred in London. In January 2005, there were 1,030 European hedge funds with assets under management of US$256 billion, of which 74 per cent were managed by managers based in the United Kingdom.[27]

In June 2005, the FSA issued two discussion papers. One paper dealt with hedge fund risks.[28] The second paper dealt with hedge funds in a retail context.[29] Hedge funds were included within the broader category of wider-range investment products, i.e., those which exhibit high degrees of volatility, illiquidity, or complexity. The term "hedge fund" is not defined in British securities law.

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[26] Commission of the European Communities, *op. cit.*
[27] Alternative Investment Management Association, Response to Discussion Paper DP 05/4, October 2005.
[28] Financial Services Authority, Discussion Paper 05/4 -- Hedge Funds: A Discussion of Risk and Regulatory Engagement, June 2005.

Following public comment, the FSA published its feedback to the two discussion papers in March 2006.[30] In its feedback, the FSA reiterated its view that hedge funds are an important part of the financial services system, providing a major source of liquidity and enhancing market efficiency as well as providing a mechanism for improving the diversification of investors' portfolios.

Hedge Fund Risks

Risks Related to the Market

Some of the risks identified by the FSA in its discussion paper relate to the market. In this context, it should be borne in mind that London is second only to New York as a location for hedge fund managers. One concern is that, through the aggressive use of leverage, hedge funds create risk not only for themselves but also for other market participants with which they deal, for instance their prime brokers. The failure of a large hedge fund, or group of hedge funds, might cause serious market disruption and an erosion of confidence.

A related concern relates to liquidity mismatch. This refers to the fact that a hedge fund's liabilities may be more liquid than its assets. For instance, if prime brokers withdraw their credit facilities or investors decide to redeem their investments *en masse*, hedge funds may be forced to sell their investments hurriedly, causing potentially disorderly markets.

The FSA is concerned that it has insufficient information on which to base decisions about the risk posed by hedge funds and regulatory action to mitigate that risk.

Risks Related to Managers

Another set of risks identified in the discussion paper relates to hedge fund managers and their business conduct. The potential risks identified by the FSA include inability or lack of incentives to create an effective control infrastructure, inadequate back office systems, weaknesses in risk management, inadequate valuation of the funds, operating at the boundaries of acceptable practice

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[29] Financial Services Authority, Discussion Paper 05/3 -- Wider-range Retail Investment Products: Consumer Protection in a Rapidly Changing World, June 2005.

[30] Financial Services Authority, Feedback Statement 06/2 -- Hedge Funds: A Discussion of Risk and Regulatory Engagement, and Feedback Statement 06/3 -- Wider-range Retail Investment Products: Consumer Protection in a Rapidly Changing World, March 2006.

concerning insider trading and market manipulation, incentives for fraud, money laundering, and conflicts of interest arising from fees paid to pension consultants.

The FSA's Proposed Response

In its feedback on the risks described above, the FSA was mindful of the need to ensure that London remains an attractive location for hedge fund managers.

In the United Kingdom, hedge fund managers typically need to be authorized. Before granting authorization, the FSA will assess the fitness and propriety of the individual members of the governing body of the firm. This includes checking individuals for adverse regulatory or financial history, criminal records, and business failures. Once authorized, the manager must establish appropriate systems and controls.

In its feedback statement, the FSA opted for incremental changes in the regulation of hedge fund managers. It proposes to add some questions to the Integrated Regulatory Returns that firms send to the FSA. The answers to these questions will enable the identification of managers that use hedge fund strategies. Where a manager is so identified, the FSA proposes to ask further questions to identify:

- the manager's prime broker (and custodian, if separate); this is designed to identify new firms offering prime brokerage services, which the FSA considers to pose more risk than established players;
- the third-party administrator; and
- the fund auditor; this is designed to ensure that the auditor belongs to a recognized professional body and has sufficient experience, given that the auditor frequently performs the sole oversight of the fund's valuations.

These proposals are subject to further consultation and cost-benefit analysis.

The FSA also created a Hedge Fund Managers Supervision team within its organization to serve as a centre of hedge fund expertise. Through AIMA, the British hedge fund industry has expressed willingness to assist the centre in its learning process.[31] We believe it would be beneficial for the regulatory authorities in Canada to set up a similar centre.

The team is responsible for relationship management with potentially high-impact hedge fund managers. The team will carry out risk assessment on these firms to review all aspects of their business.

The team will also be responsible for thematic projects, of which two have been identified as requiring priority. First, the team will carry out thematic visits on the valuation of hedge fund assets. The FSA is concerned by the conflict of interest arising from the manager's remuneration being based on performance and assets under management. This may create an incentive to overstate the value of the fund's assets. The FSA admits that the risks can be mitigated but not fully avoided.

The second immediate priority of the team will be to ensure that hedge fund managers disclose to all investors the existence of side letters and manage adequately any conflict that may arise.[32] The concern is that failure to make such disclosure would result in some, often large, investors receiving more information and preferential treatment when compared with other investors in the same class of shares. The FSA does not propose to require that the nature of individual side letters be disclosed.

Hedge Funds and Retail Investors

In principle, the British retail investor has many avenues for accessing hedge fund strategies. We say "in principle" because some of the avenues described below are very new, reflecting the current state of flux in hedge fund regulation.

Retail Hedge Fund Vehicles

As explained earlier, following the coming into force of UCITS III, absolute return products are becoming available to retail investors, sometimes with low minimum investments.

[31] Alternative Investment Management Association, *op. cit.*

British financial regulation makes a distinction between regulated and unregulated collective investment schemes. Regulated schemes are subject to a significant degree of product regulation and may be marketed to the general public. Many hedge funds are structured as unregulated collective investment schemes. Unregulated schemes are subject to no restrictions on leverage or short selling but are not freely marketable to retail investors. They may, however, be marketed to limited classes of investors such as persons who have previously invested in similar schemes. In addition, they may be marketed to investors for whom they are considered suitable by an authorized financial adviser. The financial adviser is regulated on the basis of his advice, and redress is available for investors where mis-selling occurs. The investor must be provided with certain specified information. The minimum investments required by hedge funds have declined very significantly in recent years from a typical £50,000 to £100,000 ($100,000 to $200,000) to, in some cases, £5,000 to £10,000 ($10,000 to $20,000).

British retail investors also have access to hedge fund strategies through investment trusts listed on the London Stock Exchange. From an economic perspective, these vehicles are similar to closed-end funds in Canada. Investment trusts must abide by the Listing Rules that provide, among other things, that they must carry "an adequate spread of investment risk". In other words, they must be adequately diversified. This requirement has been met by funds of hedge funds. So far, stand-alone hedge funds have not been able to satisfy this requirement but this may change in the future as interpretations evolve and more sophisticated product structures are devised. The listed fund of funds market has recently seen a number of new product launches.

The EU Prospectus Directive, which came into force in July 2005, provides that where a prospectus has been approved by the regulatory authorities in a member state, this serves as a passport throughout the EEA. This directive applies to retail investment products that are structured as securities. Some EEA countries admit hedge funds to listing. In principle, the prospectus of a hedge fund which has been listed in one member state would need to be recognized by all member states.

The EU E-Commerce Directive provides a framework for cross-border marketing by electronic means and apportions regulatory responsibility for such marketing. The directive applies to retail investment products. This means that a fund of hedge funds authorized in one member state would be available for purchase online by investors in other member states.

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[32] See section 8(iv)(h) for a discussion of side letters.

An investor can also access hedge funds by entering into a discretionary portfolio management agreement with a money manager. The latter would be able to include hedge funds in the client's portfolio. As a practical matter, there are not many money managers interested in having retail clients.

Issues Arising from Retail Access to Hedge Funds

In analyzing the issues arising from retail access to hedge funds, the FSA was pulled in two different directions. On one hand, it is concerned that investors may not understand the risk characteristics of UCITS III schemes and that they may be confused by the multiplicity of channels and vehicles. In both cases, the risk is that the investor will be sold an unsuitable investment. On the other hand, the FSA is concerned that the general prohibition on the marketing of unregulated collective investment schemes, including hedge funds, may unduly restrict access by retail investors to legitimate investment opportunities.

The FSA's Proposed Response

In its feedback statement, the FSA announced its intention to commence consultation on allowing authorized funds of hedge funds to be marketed to retail investors. The rationale for this position is well explained in this excerpt from a speech by the FSA's Asset Management Sector Leader:

> "… the FSA last week decided to consult on the basis of creating authorised, onshore funds of hedge funds. … we are living in the real world, not a world that some highly risk-averse regulator might wish to construct. In such a world, it seemed anomalous to say the least that retail investors were able to achieve exposure to hedge-fund investment techniques through a growing number of structures but not through an authorised fund structure. That onshore structure provides a number of investor protection safeguards that could augment the degree of investor protection on offer in the retail market."[33]

This initiative was favourably received by the hedge fund industry.

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[33] Dan Waters, Asset Management Sector Leader, FSA, "FSA Priorities for the Asset Management Sector", Speech delivered at The Future of Fund Management Conference, March 28, 2006.

The retail funds of hedge funds would be subject to the same regime as authorized collective investment schemes. However, they would be able to invest in stand-alone hedge funds that are themselves unregulated, including offshore funds. The retail funds of hedge funds would be subject to investment and diversification constraints that remain to be defined.

The FSA also intends to focus on two complementary areas:

- Investor education and awareness, particularly on the increasing need to diversify, to read disclosure material, and to seek advice when necessary;
- Responsibility of product providers, including the fair treatment of customers primarily through the provision of product information that is clear and suitable for its purpose.

b) Other European Countries

While the United Kingdom is in a consultation phase, other European countries have already moved to allow retail investors wider access to hedge funds.[34] The preferred vehicle to this end has been funds of hedge funds.

Germany

Germany's Investment Modernisation Act of 2004 has received much coverage. Its objectives are to:

- implement the requirements of the UCITS directive in German law;
- strengthen the German investment fund industry;
- introduce a hedge fund regime; and
- introduce a uniform tax framework for domestic and foreign investment funds.

For the first time in Germany, the act provides a legal framework for stand-alone hedge funds and funds of hedge funds. Both types of fund must be registered with the German Federal Financial Supervisory Authority ("BaFin"). Stand-alone hedge funds may only be sold by way of private

[34] Graham Phillips and Robert Mellor, "Regulators Have a Duty to Ensure the Steady Development of Hedge Funds", *AIMA Journal*, September 2005.

placement but funds of hedge funds may be publicly marketed. In either case, there is no minimum purchase amount.

Stand-alone hedge funds are subject to no limits on the use of leverage, short selling and derivatives.

Funds of hedge funds are only allowed to invest in stand-alone hedge funds (including foreign funds) and cash.[35] They are subject to diversification requirements. They may not use leverage or short selling (this, of course, applies only to the fund of funds and not to the underlying funds).

Funds of hedge funds must continuously monitor the underlying funds to ensure compliance with the rules on investment restrictions and risk. They must also be regularly provided with risk indicators by the underlying funds. The custodian bank of underlying funds or a comparable institution such as a prime broker must verify the value of the underlying fund.

The adviser of a fund of hedge funds must have adequate experience and practical knowledge of hedge fund investment.

Hedge fund managers have been quick to take advantage of the opportunities created in the German market by the Investment Modernisation Act of 2004.[36]

Other European Countries

Retail investors also have access to funds of hedge funds in Switzerland and Ireland. The minimum investment thresholds were recently abolished in Ireland. In France, retail investors may invest in funds of hedge funds subject to a low minimum investment threshold of €10,000 (approximately $14,000). In Luxembourg, hedge funds may be offered to retail investors following approval by the domestic regulator.

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[35] See section 8(iv)(c) below on the conditions to be respected by foreign underlying funds.
[36] Horst Nottmeier, Director of the Hedge Funds Division, BaFin, "Regulation of Hedge Funds in Germany", Presentation at IOSCO's 30th Annual Conference, Colombo, Sri Lanka, April 7, 2005.

iii. Asia-Pacific Region

a) Hong Kong

Hong Kong was a pioneer in allowing the public distribution of hedge funds. This was achieved by the creation of a regime individually authorizing retail hedge funds that meet certain standards. The standards were first set out by Hong Kong's Securities and Futures Commission ("SFC") in May 2002.[37] The intention was to encourage market development and benefit investors by allowing them access to a broader range of products. The standards were revised in September 2005.[38] The revisions were intended to improve the operation of the regime but did not modify its structure. This seems to imply that, with the benefit of three years' experience with the regulatory regime, the SFC is satisfied with its structure.

Retail fund authorization is in addition to the licensing (i.e., registration) of the manager. All fund managers in Hong Kong are required to be licensed, whether the funds they manage are offered only to institutional or professional investors, or to the public at large. In order to be licensed, a manager must meet certain criteria. Among others, it must have sufficient financial resources to be able to conduct its business effectively and meet its liabilities. In particular, the paid-up share capital and capital reserves must amount to a minimum of HK$1 million (approximately $150,000).

At March 31, 2005, the SFC had authorized five stand-alone hedge funds with assets under management of US$850 million and eight funds of hedge funds with assets under management of US$320 million. To place this in context, Hong Kong has a population of 7 million. The growth rate of retail hedge funds has accelerated recently.

Retail hedge funds are regulated under the Code on Unit Trusts and Mutual Funds.[39] Guaranteed funds are regulated under the same Code.

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[37] Securities and Futures Commission, Consultation Conclusions on the Offering of Hedge Funds, May 2002.
[38] Securities and Futures Commission, Consultation Conclusions on Consultation Paper on the Review of Chapter 8.7 of the Code on Unit Trusts and Mutual Funds, September 2005.
[39] Securities and Futures Commission, Code on Unit Trusts and Mutual Funds, April 2003, as subsequently amended.

How Retail Hedge Funds Fit Within the Mutual Fund Regime

In Hong Kong, all mutual funds have some latitude to use short selling, leverage, and derivatives for investment purposes. Short selling is permitted up to 10 per cent of the total net asset value, borrowing up to 25 per cent and derivatives for investment (as opposed to hedging) purposes up to 20 per cent. Retail hedge funds are not subject to any constraint on the use of short selling, leverage, and derivatives but need to meet a number of other requirements.

We may classify these requirements under three main heads: the qualifications of the manager and prime broker, the minimum subscription levels, and the characteristics and operation of the fund.

Qualifications of the Manager and Prime Broker

One set of standards relates to the qualifications of the hedge fund manager and the prime broker. In particular, the qualifications of the manager are closely defined. The SFC has announced that it intends to use a holistic approach in assessing the acceptability of a manager.

The manager (or the adviser where the investment management function has been delegated to the latter) must have the requisite competence and expertise and be adequately staffed. There must be at least two key employees each having at least five years' general hedge fund experience and two years' specific experience of the proposed investment strategy or, in the case of funds of hedge funds, specific investment management experience as a manager of funds of hedge funds. The manager must manage at least US$100 million of hedge fund assets and have in place internal controls and risk management systems, including a clear risk management policy and written control procedures. In the case of a fund of hedge funds, the manager must have in place a due diligence process for the selection of the underlying funds and ongoing monitoring of their activities.

The above requirements effectively imply that, prior to offering retail hedge funds, the manager must have managed hedge funds on behalf of institutional or high net worth clients.

The prime broker must be a substantial financial institution subject to prudential regulatory supervision.

A Segmentation Approach

Authorized hedge funds are described as retail hedge funds in the sense that they may be distributed to the general public. However, this does not mean that they may be purchased by everybody. Except for principal-protected products, the SFC has so far opted for a market segmentation approach rather than one of full public offering. Segmentation is achieved through minimum subscription levels that effectively exclude smaller retail investors. It seems that the intention is to open up the distribution of retail hedge funds to a wider public over time as more experience of the process is gained.

There is a minimum subscription of US$50,000 in the case of stand-alone funds and US$10,000 in the case of funds of hedge funds. There is no minimum subscription where there is at least 100 per cent capital guarantee.

Typically, an investor new to hedge funds will allocate 5 per cent of his portfolio to hedge funds. For diversification reasons, it is best for this portion of the portfolio to be represented by a fund of hedge funds. Given the minimum investment of US$10,000 for a fund of hedge funds, this implies that the investor should have investable assets of at least US$200,000. This corresponds to the category of clientele that is sometimes referred to as "mass affluent".

Characteristics and Operation of the Fund

Another set of standards relates to the characteristics and operation of the fund. These are designed to further protect the investor by providing for the mandatory inclusion of high-water marks[40] in the calculation of performance fees, proper fund diversification, liquidity, fair and independent valuation, adequate disclosure, and regular reporting.

Performance fees at the level of the retail fund must be subject to a high-water mark. In the case of funds of funds, the offering document must disclose whether a performance fee is levied at both the level of the fund of funds and that of the underlying funds as well as the bases on which performance fees are calculated by the underlying funds.

[40] See section 5(vi)(a) for a description of high-water marks.

In order to ensure proper diversification of funds of funds, they must invest in at least five underlying funds with not more than 30 per cent of their assets in any one fund.

Investors should be able to redeem their securities at least once a month. The manager may require prior notice but must in any case pay the redemption proceeds within 90 days of receiving notice. Lock-ups are not allowed.

The SFC introduced an important change in September 2005. Previously, the fund's investments were required to be fairly valued. They are now required to be *independently* and *fairly* valued. We believe that the requirement for independent valuation goes some way towards meeting the concerns on the valuation of hedge funds.

The offering document must disclose all relevant matters relating to the investment operations and risk management aspects of the fund, and the manager must issue regular reports to investors at least once every quarter.

b) Singapore

Singapore was one of the very first jurisdictions worldwide to allow the sale of hedge funds to the public. The Monetary Authority of Singapore ("MAS") first introduced guidelines to this effect in June 2001. These were revised in December 2002 to lower the minimum subscription levels for funds of hedge funds and capital-protected and capital-guaranteed hedge funds, and to require enhanced disclosures. The reporting requirements for retail hedge funds were further revised in March 2005. The MAS does not regulate hedge funds that are offered only to institutional or sophisticated investors.

How Retail Hedge Funds Fit Within the Mutual Fund Regime

Retail hedge funds are regulated under the Code on Collective Investment Schemes, as are capital-protected and capital-guaranteed hedge funds.[41] Collective investment schemes are generally prohibited from short selling, investing in derivatives, or borrowing, except to meet redemptions or for short-term bridging requirements. Retail hedge funds do not have to observe these investment constraints but need to meet a number of other requirements in order to be authorized by the MAS.

The process of authorizing a retail hedge fund or, for that matter, any collective investment scheme is in addition to the licensing of the manager.

As in Hong Kong, the requirements for retail hedge funds may be classified under three main heads: the qualifications of the manager, the minimum subscription levels, and the characteristics and operation of the fund.

Qualifications of the Manager

The manager (or an adviser to which investment decisions have been outsourced) must have at least two executives who each have at least five years' experience in the management of hedge funds. In the case of funds of hedge funds, at least three of the five years' experience must be in the management of funds of hedge funds.

Unlike in Hong Kong, there is no minimum asset requirement.

Minimum Subscriptions

In Singapore too, the regulator decided to use a segmentation approach based on minimum subscription levels.

There is a minimum initial subscription of S$100,000 ($70,000) per investor in the case of stand-alone hedge funds and S$20,000 ($14,000) in the case of funds of hedge funds. These amounts are similar to those required in Hong Kong. There is no minimum subscription in the case of hedge funds where at least 100 per cent of the amount invested is protected.

Characteristics and Operation of the Fund

The manager is responsible for putting in place proper risk management and monitoring procedures and internal controls.

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[41] The Monetary Authority of Singapore, Code on Collective Investment Schemes, Updated October 2005.

Retail hedge funds must file a prospectus which, among other things, explains the material differences between the hedge fund and other types of fund. They must also provide their investors with reports on a quarterly basis. The contents of the quarterly, semi-annual, and annual reports are prescribed. Interestingly, retail hedge funds are not required to disclose a portfolio statement or the top 10 holdings where the manager and trustee believe that disclosure is prejudicial to the fund. Instead, they may analyze the fund's aggregate exposure according to country, industry, asset class, and/or credit rating of debt securities.

Investors must be allowed to redeem their units at least once every quarter.

Funds of hedge funds must be properly diversified. They are required to be invested across at least 15 managers of stand-alone hedge funds or have no more than 8 per cent of their assets allocated to a single manager.

c) Other Asia-Pacific Countries

Hedge funds may also be marketed to the public in Australia and Japan following registration with the regulatory authorities.[42]

Approximately AUS$30 billion ($40 billion) have been invested in hedge fund products by Australian investors, of which nearly half is thought to have been sourced from retail investors.[43]

iv) Summary Table

We have summarised in Table 2 certain aspects of the regulation of hedge funds in the jurisdictions surveyed.

For a much more complete comparison, reference should be made to the recent IOSCO survey.[44]

[42] Graham Phillips and Robert Mellor, *op. cit.*
[43] Alternative Investment Management Association, Response to Discussion Paper DP 05/3, October 2005.
[44] Technical Committee of the International Organization of Securities Commissions, The Regulatory Environment for Hedge Funds: A Survey and Comparison (Consultation Report), March 2006.

Table 2
Comparison of Hedge Fund Regulation in Select Jurisdictions

	Canada	**US**	**UK**	**Hong Kong**	**Singapore**
Is manager registration required?	No	No	Yes	Yes	Yes
Is adviser registration required?	Yes	Yes, since Feb 1, 2006	Yes	Yes	Yes
Is there a general purpose regime for retail hedge funds?	No	No	Under consideration	Yes	Yes
If yes, are retail hedge funds part of the mutual fund regime?	NA	NA	Under consideration	Yes	Yes
Are stand-alone funds allowed?	NA	NA	No	Yes	Yes
Are funds of hedge funds allowed?	NA	NA	Under consideration	Yes	Yes
Are there minimum purchase amounts?	NA	NA	Undecided	Yes	Yes
Is the adviser required to have prior hedge fund experience?	NA	NA	Undecided	Yes	Yes
Must manager manage a minimum anount of hedge fund assets before being allowed to launch retail hedge funds?	NA	NA	Undecided	Yes	No

5. The Canadian Hedge Fund Industry

In this section, we discuss the structure of the Canadian hedge fund industry. We briefly describe the various parties involved in the operation of a hedge fund. We review the commercial and legal hedge fund structures used in Canada. We discuss the various market segments and the distribution of hedge funds, including the relevant regulatory exemptions. We analyze the remuneration of hedge fund managers and intermediaries, and discuss hedge fund disclosure. Finally, we quote some statistics to illustrate the size and growth of the Canadian hedge fund industry.

The focus of this section will be mainly descriptive. We shall defer a discussion of our concerns until the next two sections of the report.

i) Operation of a Hedge Fund

The manager takes the initiative in setting up the hedge fund. For this reason, it is sometimes known as the sponsor, promoter, or manufacturer. Once the fund has been set up, the manager is responsible for its operation. In practice, many of the tasks involved in running a hedge fund are outsourced to service providers.

The adviser advises the manager on the management of the fund's investment portfolio. The adviser may be the same entity as the manager.

The prime broker is an essential service provider. In Canada, the prime broker is often a unit of a Canadian bank. It performs most of the tasks involved in operating a hedge fund, except for the management of the investment portfolio and the back office functions. Among other services, the prime broker may execute and clear trades, take charge of the custody of the securities, provide the margin financing required for the fund to use leverage, lend the stocks required for the fund to sell securities short, and provide reports of the positions held by the fund. The prime broker may also introduce investors to the fund.

The administrator is another service provider. It essentially takes care of the back office. Among other things, it may receive and process subscription and redemption requests, maintain investor records, price the fund's securities and calculate the fund's net asset value, calculate management and performance fees, and prepare the fund's financial statements.

a) Registration Requirements

The adviser must be registered with the securities commissions. For registration to be granted and subsequently maintained, the adviser must comply with certain proficiency, capital, insurance, record keeping, and other requirements.

The manager does not need to be registered *qua* manager. If the manager also performs the role of adviser, it will need to be registered as such. If the manager is involved in marketing activities, this constitutes solicitation, which is a form of trading in securities and requires registration as a dealer.

The prime broker needs to be registered.

ii) Commercial Structure of Hedge Funds

In Canada, hedge funds are offered using three main commercial structures: stand-alone hedge funds, funds of hedge funds, and principal-protected notes.

We are being internally consistent in including principal-protected notes, which are distributed to retail investors, among hedge fund structures. At the beginning of section III, we expressly excluded private distribution as a characteristic of hedge funds.

a) Stand-Alone Hedge Funds

Stand-alone hedge funds are usually advised by a single adviser according to one of the investment strategies discussed in section 3(iv). For this reason, they are sometimes known as single-manager funds.

b) Funds of Hedge Funds

Funds of hedge funds invest in securities of stand-alone hedge funds. The latter are sometimes referred to as the underlying funds. More than 90 per cent of the assets of Canadian funds of hedge funds are invested in underlying U.S.-based hedge funds.[45] This illustrates the global nature of the hedge fund industry.

The value added by the manager of a fund of funds lies mainly in the due diligence it performs on prospective underlying funds and their managers. When properly conducted, the due diligence of a hedge fund manager is complex and expensive.[46] A track record of superior investment performance is normally necessary for a manager to be considered for inclusion in a fund of hedge funds. However, this is by no means sufficient. Even more important are factors such as the reputation of the principals, the length of time they have been in business, the amount of their own money that they have invested in the fund and the conditions of investment, the absence of any legal or regulatory antecedent, the continuity in the investment management team, the financial strength of the firm, its investment discipline, and its risk management process. Some funds of funds even look into the private life of the principals of the underlying funds for clues to their moral fibre.

Once included in a fund of funds, the underlying funds will be constantly monitored for performance. If an underlying fund consistently underperforms, it may be removed from the fund of funds.

If the current investment strategy of an underlying fund does not generate satisfactory results, its adviser may be tempted to change the strategy. This is sometimes referred to as “style drift” and will upset the diversification of the fund of funds, whose investment program was designed to achieve a given mix of strategies. An important responsibility of the manager of the fund of funds is to ensure that the underlying funds do not exhibit style drift.

Besides the selection and monitoring of the underlying funds, the manager of a fund of hedge funds is also responsible for the design of the investment program. This will be done in such a way as to achieve diversification across investment strategies and managers.

We noted in section 3(iv) that different hedge fund strategies involve different risks. To be most beneficial, an investor’s investment in hedge funds should be diversified across several different

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45 Investor Economics, Hedge Funds Report, Winter 2005.

46 See Scot Blythe, “Beyond 60/40”, *Benefits Canada*, August 2005, where it is reported that, at a major Canadian pension fund, due diligence on a single manager costs an estimated $75,000 to $100,000.

strategies. Funds of hedge funds are designed with such diversification in mind and are less risky than stand-alone hedge funds.

Multi-Adviser Funds

A variant of the fund of hedge funds is the multi-adviser fund. Here, instead of being invested in underlying stand-alone funds, the assets of the fund are allocated to a number of advisers, each of which manages its account using a different investment strategy.

Multi-adviser funds are as suitable as funds of hedge funds for diversification purposes. They have the added benefit of reducing operational risk because the account of each adviser is fully transparent to the manager of the fund.[47] This reduces the risk of the portfolio being overpriced as well as the possibility of style drift. The risk of fraud by the adviser is also reduced. The downside is that an account needs to be fairly sizeable in order to attract an adviser.

c) Principal-Protected Notes

Principal-protected notes are a form of structured product. The return of a structured product is linked to that of an underlying investment that can, for example, be a stock index, a basket of mutual funds, or a fund of hedge funds.

Whenever we use the expression "principal-protected note" in this report, we do so in the limited sense of those structured products that use hedge funds as the underlying investment.[48]

Principal-protected notes promise to their investors that, at maturity, they will get back at least the original amount invested. The term to maturity of a principal-protected note can be seven years or more.[49]

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

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[47] Jean-René Giraud, Mitigating Hedge Funds' Operational Risks: Benefits and Limitations of Managed Account Platforms, EDHEC, June 2005.

[48] A broader discussion of structured notes can be found in the companion report *Implications of the Use of Investment Wrappers*.

funds (usually funds of hedge funds) as the underlying investment. Independent managers of principal-protected notes work in partnership with banks or Crown corporations[50]. The notes are sponsored and distributed by the manager but issued by the bank[51] or Crown corporation.

Crown Corporations as Issuers of Principal-Protected Notes

Crown corporations are willing to lend their name and credibility to principal-protected notes because it lowers their cost of borrowing. The savings are effectively funded by the retail investors who buy the principal-protected notes.

Protection Structures May Reduce the Participation Rate

Principal-protected notes normally include a mechanism or structure to reduce the risk involved in providing the principal protection. From an investment perspective, these structures constitute a constraint and may reduce the participation rate, which is the extent to which the investor is able to participate in the return of the underlying fund.[52] Some structures are more efficient than others in the sense that they allow a higher participation rate.

The main protection structures in use are described in the companion report *Implications of the Use of Investment Wrappers*.

There is No Principal Protection When Selling on the Secondary Market

The manager sometimes establishes a secondary market for note holders who wish to sell their notes prior to maturity. Sometimes, there are redemption privileges. In both of these cases, the principal protection does not apply.

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[49] A recently marketed principal-protected note has a term to maturity of 13.5 years.
[50] We use the expression "Crown corporation" to include agencies such as the Canadian Wheat Board which are not Crown corporations proper but whose debt is irrevocably and unconditionally guaranteed by the Government of Canada.
[51] In these cases, they are subject to the Bank Act and regulations thereunder.
[52] For instance, if the underlying hedge fund generates an annual return of 10 per cent and the principal-protected note generates a return of 7 per cent (less the expenses at the level of the principal-protected note), this corresponds to a participation rate of 70 per cent.

iii. Legal Structure of Hedge Funds

Domestic stand-alone hedge funds and funds of hedge funds usually take the legal form of a limited partnership or trust.

Principal-protected notes take the legal form of a debt instrument of the issuer, normally a bank or a Crown corporation.

a) Offshore Funds

Some Canadian hedge fund managers have incorporated stand-alone hedge funds and funds of hedge funds in offshore jurisdictions such as the Cayman Islands and the Channel Islands. These funds are mainly intended for offshore clients. Following the introduction of new rules on the taxation of foreign investment entities, it is now less tax-efficient for taxable Canadian investors to invest in offshore funds.

iv. Other Retail Hedge Fund Vehicles

Principal-protected notes are mainly held by retail investors. In addition, retail investors have access to a number of other investment vehicles offering hedge fund strategies. The available vehicles all have drawbacks of their own and none has become as popular as principal-protected notes.

a) Closed-End Funds

Under securities legislation in the jurisdictions of Canada, the distribution of a security normally requires the involvement of a registered dealer and the filing of a prospectus. A small number of listed closed-end investment funds offer hedge fund strategies to retail investors in compliance with these requirements.

The drawbacks of closed-end funds in general are well known. For a start, the issue costs immediately reduce the fund's net asset value by about 6 per cent. In addition, most closed-end funds trade at a discount to their net asset value.

In order to facilitate their initial distribution, closed-end investment funds usually provide their shareholders with an annual redemption privilege at net asset value. From the perspective of the manager, this is a flaw in the design of the product. Rather than sell their shares on the stock exchange at a discount to net asset value, shareholders in need of liquidity naturally prefer to redeem their shares at net asset value. There is often a rush for the exit on each redemption occasion, especially when the fund's returns are disappointing.

Closed-end funds may also be thinly traded on the exchange and, therefore, lack liquidity.

b) Life Insurance Products

Hedge funds are accessible within a small number of segregated funds and universal life insurance policies. The latter are investment vehicles bundled with certain insurance features. The insurance features are not needed by all investors, and they make the product more expensive.

One of the insurance features of segregated funds is a protection of capital (usually to the extent of 75 per cent of the amount invested) at death or if the fund is held until maturity, which is at least ten years after purchase. A capital protection for investment funds that are held for a long period of time is probably not necessary except for conservative investors.[53]

c) Mutual Funds with Exemptive Relief

Mutual funds are not a vehicle for offering hedge fund strategies because National Instrument 81-102 *Mutual Funds* ("NI 81-102") does not allow mutual funds to use short selling and leverage for investment purposes. However, certain mutual funds have obtained exemptive relief to use short selling to a limited extent, usually up to 10 per cent of the net asset value.

d) Commodity Pools

Canadian retail investors also have access to a limited range of hedge fund strategies through commodity pools.

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[53] This point is discussed in greater detail in section 2.

Commodity pools are a special type of mutual fund. They are subject to the same regulations as other mutual funds and to the overriding special provisions of NI 81-104. The latter provides, among other things, that:

- Commodity pools may invest in commodities;
- Commodity pools may use derivatives to implement leverage and short selling;
- Commodity pools may only be sold through individuals who meet certain proficiency requirements and who are supervised by appropriately qualified supervisors;[54]
- The manager of a commodity pool may charge performance fees without reference to a benchmark or index;
- Provided this is disclosed in the prospectus, a commodity pool may impose a lock-up for a period up to six months; and
- Commodity pools must file a long-form prospectus rather than the simplified prospectus available to other mutual funds under National Instrument 81-101 *Mutual Fund Prospectus Disclosure* ("NI 81-101").

NI 81-104 was issued in order to replace and update an existing policy on commodity pools and was not intended to be a retail hedge fund regime. However, because it takes into account certain particular features of hedge funds, it may be described as an embryonic retail hedge fund regime.

There has been renewed interest in commodity pools lately, reflecting the current interest in alternative investments generally. New commodity pools were brought to market as recently as the beginning of 2006.

v. Market Segments and Distribution

The distinction between the types of hedge fund is important because different types are intended for different market segments, are distributed differently, and carry different levels of fees.

[54] This requirement does not apply in British Columbia.

a) Stand-Alone Hedge Funds and Funds of Hedge Funds

Stand-alone hedge funds and funds of hedge funds are distributed to high net worth individuals and institutional investors.

High net worth individuals are reached either directly by the manager or through an intermediary. Because of the nature of the clientele, the intermediary is often a representative of an investment dealer.

Institutional investors such as pension plans invest mainly in funds of hedge funds because they are attracted by the diversified nature of the product. Institutional investors are particularly mindful of diversification because they owe a fiduciary responsibility to third parties, e.g., pension plan members. Managers of funds of hedge funds approach institutional investors either directly or through the institution's consultant.

Regulatory Exemptions

As noted in section 5(iv), the distribution of a security normally requires the involvement of a registered dealer and the filing of a prospectus. Stand-alone hedge funds and funds of hedge funds are distributed under an exemption from these requirements.

National Instrument 45-106 *Prospectus and Registration Exemptions* ("NI 45-106"), which came into force on September 14, 2005, in every jurisdiction of Canada, has substantially harmonized the exempt distribution regime across the country. The main exemptions available to investment funds are:

- the accredited investor exemption;
- the minimum purchase exemption;
- the investment fund reinvestment exemption;
- the additional investment in investment funds exemption; and
- the offering memorandum exemption.

The Accredited Investor Exemption

The dealer registration and prospectus requirements do not apply if the purchaser is an accredited investor acting as principal. The rationale for this exemption is that accredited investors are sophisticated and able to withstand financial loss. The various categories of accredited investor are now largely uniform across Canada and include, among others:

- A Canadian financial institution (which includes Schedules I and II banks), or a Schedule III bank;
- A person registered as an adviser or dealer in Canada, other than a limited market dealer;
- The Government of Canada and provincial, territorial, and municipal governments, and their agencies;
- A regulated pension fund;
- An individual who, alone or with a spouse, has net financial assets exceeding $1,000,000 or net assets of at least $5,000,000;
- An individual whose net income before taxes exceeded $200,000 (or $300,000 when taking the spouse's income into account) in each of the two most recent calendar years and who expects to exceed that net income level in the current calendar year;
- A person, other than an individual or investment fund, who has net assets of at least $5,000,000 as shown on his most recent financial statements;
- An investment fund that distributes its securities only to accredited investors or other persons meeting certain specified requirements or that is advised by a registered adviser;
- A registered adviser when managing a fully managed account (but see the note below); and
- A registered charity that has obtained advice from a registered adviser.

Note:

In Ontario, a registered adviser acting on behalf of a fully managed account does not qualify as an accredited investor if it is purchasing a security of an investment fund, unless exemptive relief is obtained. We understand that this is due to concerns about this exemption being used to hold hedge funds within fully managed accounts.

When a person qualifies as an accredited investor, he may purchase a security in any amount. There is obviously nothing to prevent the hedge fund manager and intermediary from imposing minimum purchase amounts of their own.

The Minimum Purchase Exemption

This exemption applies when a person purchases a security in an amount not less than $150,000 and pays in cash at the time of the trade. This threshold is now uniform throughout Canada.[55] The purchase must be in respect of a security of a single issuer. This means that the investor cannot allocate the $150,000 among several funds, even of the same family.

We note that the web sites of certain hedge fund managers still refer to the lower minimum thresholds that applied in certain provinces prior to NI 45-106.

The Investment Fund Reinvestment Exemption

This exemption is available when dividends or distributions by an investment fund are reinvested in securities of the same class or series. Certain requirements must be observed for this exemption to be available.

The Additional Investment in Investment Funds Exemption

There is an exemption when an investor acquires additional securities of an investment fund which the investor has previously purchased in cash in an amount not less than $150,000, provided that the investor still holds securities with a cost or net asset value of not less than $150,000.

The Offering Memorandum Exemption

This exemption requires that the investors receive an offering memorandum in the required form. In some jurisdictions, the investment fund must be a reporting issuer. In other jurisdictions, it must additionally be listed on a stock exchange or quoted on an over the counter market. In Ontario, this exemption is not available.

b) Principal-Protected Notes

Principal-protected notes were developed as a vehicle to offer hedge fund strategies to retail investors**.** They can be bought in small amounts.

As noted above, securities legislation in the jurisdictions of Canada normally requires the involvement of a registered dealer for a trade in securities. There is an exemption in respect of a trade in certain securities, including, by way of example, debt instruments of the Government of Canada, provincial, territorial, and municipal governments, Schedule I and Schedule II banks, trust companies, insurance companies, credit unions, and *caisses populaires.*[56]

Because principal-protected notes constitute a debt instrument of the issuer, usually a bank or Crown corporation, they are distributed under this exemption.[57]

Principal-protected notes are not covered by deposit insurance.

c) High Net Worth and Retail Investors Defined

In this report, we frequently refer to "high net worth" and "retail" investors. We are now in a position to give a precise definition to these terms.

By "high net worth" investors, we mean individual investors who qualify as accredited investors or under another exemption. We refer to all other individual investors as "retail" investors.

[55] There are transitional provisions.
[56] See, for example, s. 35(2)1 of the Securities Act (Ontario). See also s. 2.34(2) of NI 45-106.
[57] In Ontario and in Newfoundland and Labrador, a person trading as an intermediary under an exemption must be registered as a limited market dealer.

d) FundSERV

When investment funds are distributed by intermediaries, this is often done through FundSERV, which operates like a clearing house for purchase and redemption orders. Rather than submit its clients' orders to each manager individually, the intermediary submits the orders to FundSERV which then routes the orders to the appropriate manager.

vi) Remuneration of Hedge Fund Managers

Stand-alone hedge funds and funds of hedge funds generally have several classes of security, of which the most common are called Class A and Class F.

Class A and Class F Securities

Class A securities are purchased by investors with commission-based brokerage accounts and Class F by those with fee-based brokerage accounts. In a commission-based account, the investor pays the intermediary a commission every time he buys or sells a security. In a fee-based account, the investor does not pay a transaction-based commission. Instead, he pays the intermediary a periodic fee based on the assets under management. Commission-based brokerage accounts are the more common although fee-based accounts are gaining ground.

The hedge fund manager's remuneration takes the form of a management fee and a performance fee. These vary according to the type of commercial fund structure and class of security.

a) Stand-Alone Hedge Funds

Managers of stand-alone hedge funds generally charge an annual management fee of 1 per cent to 2 per cent of assets under management in respect of Class A securities together with a performance fee of 20 per cent of the fund's return. In the case of Class F securities, the management fee is reduced by 0.75 to 1.00 percentage point. From the investor's perspective, this reduction offsets to some extent the periodic asset-based fee he pays to the intermediary.

The performance fee is sometimes subject to a hurdle rate or a high-water mark. A hurdle rate is a minimum rate of return that the fund must exceed before the manager becomes entitled to a performance fee. Most Canadian hedge funds do not feature a hurdle rate.[58] A high-water mark is designed to prevent the manager from earning a performance fee when it is merely recouping previous losses. This is achieved by requiring the value per unit of the fund to be higher than the previous peak, known as a high-water mark, before a performance fee is earned. The high-water mark may be permanent or it may be reset at periodic intervals. If a fund drops considerably below a permanent high-water mark, the manager may lose all hope of ever earning performance fees and may decide to wind up the fund.

b) Funds of Hedge Funds

Managers of funds of hedge funds generally charge an annual management fee of 1 per cent in respect of Class A securities plus a performance fee of 10 per cent of the fund's return. The management fee is reduced in the case of Class F securities. The fees charged by the manager of the fund of hedge funds are obviously on top of the fees charged by the managers of the underlying hedge funds.

c) Principal-Protected Notes

Principal-protected notes are usually funds of hedge funds with a principal guarantee. In addition to the management and performance fees incurred at the levels of the fund of funds and the underlying funds, principal-protected notes carry structuring and guarantee fees.

The essential point is that stand-alone hedge funds have one level of fees, funds of hedge funds up to two levels, and principal-protected notes up to three levels.

[58] Investor Economics, *op. cit.*

vii) Remuneration of Intermediaries

The forms of compensation to intermediaries are similar to those in the mutual fund industry and include sales commissions and trailers. By definition, sales commissions apply only in the case of Class A securities.

a) Stand-Alone Hedge Funds

Where the client holds a commission-based brokerage account, the intermediary collects a negotiable sales commission from the client at the time of sale. It also receives from the hedge fund manager an annual trailer, generally calculated as 1 per cent of the assets administered by the intermediary. In some cases, the hedge fund manager will also pay to the intermediary a share, generally 10 per cent, of any performance fee.[59]

Where the client holds a fee-based brokerage account, the intermediary collects from his client a periodic fee based on assets under management. It does not receive a trailer fee from the hedge fund manager. This is why the manager can afford to charge a lower management fee on Class F than on Class A securities. However, the intermediary does receive a share of performance fees, if applicable.

b) Funds of Hedge Funds

The intermediary's remuneration in the case of funds of hedge funds is similar to that for stand-alone hedge funds, sometimes with the added complication of a deferred sales charge ("DSC").

Deferred Sales Charges

Some funds of hedge funds offer their clients the choice of a DSC. Only clients with a commission-based brokerage account will want to use this. Here, the client does not pay a commission to the intermediary at the time of sale. Instead, the hedge fund manager does. In this case, the manager will pay the intermediary a fixed commission, usually amounting to 5 per cent

[59] By way of contrast, managers of publicly offered mutual funds are prohibited by National Instrument 81-105 *Mutual Fund Sales Practices* ("NI 81-105") from offering this form of compensation to intermediaries.

of the amount of the transaction. The manager will recoup this in two ways. First, if the client redeems the securities within a stipulated time, say, six years, the manager will charge the client a DSC (also known as a redemption fee) which is usually calculated as a percentage of the market value of the securities being redeemed. This percentage decreases over time. Secondly, the manager will pay the intermediary a reduced trailer, normally at the annual rate of 0.50 per cent of assets instead of the full 1 per cent. The intermediary will also receive a share of performance fees, if applicable.

When DSCs are used, they substantially change the business model of the manager. In particular, they increase the manager's requirements for cash. In order to be able to pay the sales commissions to intermediaries, the manager must generate the cash internally or have access to additional capital. Indeed, such access is a competitive advantage.

c) Principal-Protected Notes

The intermediary's remuneration in the case of principal-protected notes parallels that for funds of hedge funds.

Managers of principal-protected notes offer particularly attractive compensation to intermediaries. An egregious example is provided by a manager who, at one time, was offering a 4 per cent sales commission plus a 2 per cent annual trailer. We believe that it is a cause for concern when the intermediary stands to profit more from an investment than the investor, as is possible with this kind of remuneration package.

viii) Disclosure

Since hedge funds are distributed under an exemption, they do not provide their investors with a prospectus. Instead, they provide a disclosure document known as an offering memorandum (in the case of stand-alone hedge funds and funds of hedge funds) or an information statement (in the case of principal-protected notes). The content of these documents is not prescribed.

With a view to promoting sound disclosure and promotion practices in the hedge fund industry, the Canadian chapter of AIMA ("AIMA Canada") took the laudable initiative of publishing a reference guide for Canadian hedge fund managers.[60] The guide is applicable to all hedge fund structures.

The guide contains recommendations on the contents of an offering memorandum. These recommendations generally parallel the disclosure requirements for simplified prospectuses. The guide also makes recommendations on the contents of an information statement.

In addition, the guide addresses the marketing and promotion of hedge funds. It recommends that, whether in the course of private or public offerings, hedge fund managers should adhere to the current standards of sales practices as they apply to mutual funds. The rules governing the sales practices of mutual funds are set out in NI 81-105. We fully endorse this recommendation.

When presenting performance data, the guide allows a choice of showing returns gross or net of all fees, although the method of calculation should be disclosed. We note that this is inconsistent with the practice of publicly offered mutual funds, which are required by NI 81-102 to show their returns net of all fees and expenses.

The guide also permits the publication of back-tested performance data provided they are indicated as such. [61] Back-tested performance data refer to the returns that would have been obtained in past periods prior to the creation of the fund *if* the fund's investment strategy had been applied in those periods. In our view, this kind of data is rather less than helpful. Investment strategies have a disconcerting habit of performing exceedingly well during back-testing but rather less so when applied in real life.

ix) Size of the Canadian Hedge Fund Market

The size of the hedge fund market is difficult to measure because hedge funds are like nested dolls. Stand-alone hedge funds are found within funds of hedge funds and the latter within principal-protected notes.

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[60] Alternative Investment Management Association (Canadian chapter), Guide to Sound Practices for Disclosure and Promotion of Alternative Investments in Canada, June 2005.

Investor Economics estimates the overall Canadian hedge fund market at $27.9 billion of assets under management in December 2004.[62] Let us provide some context. The global hedge fund market is estimated at around US$1.1 trillion. This means that Canada represents approximately 2 per cent of the global hedge fund market.

As shown in Table 3 below, the total assets of $27.9 billion comprise $10.9 billion held by Canadian pension plans, $15.4 billion held by Canadian individuals and $1.6 billion held by foreign clients of Canadian managers.

Table 3
Size of the Canadian Hedge Fund Market
Assets under Management ($ billions)
December 2004

Pension plans (See note)		10.9
Stand-alone hedge funds	4.1	
Funds of hedge funds	2.5	
Total High Net Worth Market	6.6	
Retail market (principal-protected products)	8.8	
Total Individual Market		15.4
Foreign clients of Canadian managers (See note)		1.6
TOTAL CANADIAN MARKET		27.9

Note: As at June 2004

Source: Investor Economics

[61] Contrast this with National Instrument 81-106 *Investment Fund Continuous Disclosure* ("NI 81-106") which prohibits investment funds which are reporting issuers from providing performance data for any period if the investment fund was not a reporting issuer at all times during the period.
[62] Investor Economics, Hedge Funds Report, July 2005 Semi-annual Update.

a) Canadian Pension Plans

Hedge funds in Canadian pension plan assets amounted to $10.9 billion. This includes assets managed by Canadian managers as well as by foreigners. There is no breakdown of the figure between the two. However, we believe that most of the assets are managed by U.S. managers.

b) Canadian Individuals

In December 2004, hedge fund assets managed by Canadian hedge fund managers on behalf of individual clients in Canada amounted to $15.4 billion. This includes $6.6 billion on behalf of high net worth clients and $8.8 billion on behalf of retail clients. Although these figures must be used with caution, they indicate that the retail market for hedge funds is larger than the high net worth market.

The market for individual clients has experienced rapid growth. Assets grew by 28 per cent every year , and at a compound annual rate of 43 per cent over the past five years since December 1999.

The $15.4 billion of assets represented 200 funds managed by 78 managers. The average fund held $77 million of assets and the average manager managed $197 million.

High Net Worth Market

The $6.6 billion of assets managed on behalf of high net worth clients take the form of stand-alone hedge funds ($4.1 billion) and funds of hedge funds ($2.5 billion). Please note that this figure provides only an incomplete picture of the hedge fund market for high net worth investors because it does not include hedge fund assets managed by foreign managers on behalf of Canadian individuals.

Retail Market

The $8.8 billion of assets managed on behalf of retail clients take the form of principal-protected products.

x) AIMA Canada

AIMA Canada is the trade association of the Canadian hedge fund industry. Founded in March 2003, it had over 70 corporate members in June 2005. It contributes to enhanced business practices among hedge fund managers, for instance, through guides to sound practices, and a better understanding of hedge funds by investors. We believe that the hedge fund industry is in a position to play an important role in these areas.

AIMA's international headquarters are in London. Its membership includes hedge fund managers, institutional investors, prime brokers, exchanges, fund administrators, auditors, lawyers, and other service providers.

xi) The Canadian Hedge Fund Industry Comes of Age

On March 1, 2006, Scotia Capital launched the first Canadian hedge fund index. The Scotia Capital Canadian Hedge Fund Performance Index exclusively comprises hedge funds advised by Canadian advisers, with a minimum of $15 million in assets under management and an *audited* 12-month track record.

Initially, the index is a broad index encompassing all hedge fund strategies. There are future plans for sub-indices devoted to specific investment strategies. It is likely that the index will raise the profile of Canadian hedge fund advisers, both domestically and internationally.

In 2005, the Scotia Capital Canadian Hedge Fund Performance Index returned 16.59 per cent on an asset-weighted basis.[63]

6. <u>Macro Issues</u>

i) Systemic Risk

Systemic risk relates to the risk of serious market disruption caused by the failure of a large, highly leveraged hedge fund or group of hedge funds.

In the wake of the Asian and Russian crises and the near-collapse of Long-Term Capital Management in 1998, the Financial Stability Forum ("FSF") set up a working group to examine concerns raised by highly leveraged institutions, i.e., large, highly leveraged hedge funds. Key among the recommendations of the working group was the strengthening of risk management practices by counterparties and highly leveraged institutions.[64]

In a subsequent review of progress towards the implementation of the recommendations, the FSF concluded that, although the extent of improvements might be uneven, counterparty risk management with regard to hedge funds had improved as had the risk management practices of hedge fund themselves. Both hedge funds and counterparties pointed to the absence of significant hedge fund failure or market disruption despite significant stresses on the system (the bursting of the tech bubble in 2000, the events of September 11, 2001, the collapse of Enron, Argentina's default, etc.) as testimony to the effectiveness of the improvements they had made in risk management practices.[65]

More recently, events relating to General Motors seem to confirm the improvement in hedge fund risk management practices. In 2005, the price of General Motors' convertible debt dropped because of credit-rating downgrades at the same time that its stock price rose as a result of purchases of stock by a private investor. This combination of factors was very negative for hedge funds using a convertible arbitrage strategy.[66] Although many hedge funds probably suffered large losses, there was no large-scale failure.

The FSF continues to monitor the hedge fund industry as part of its ongoing responsibility to share the international experience and perspectives of its members.

a) Indirect Regulation of Hedge Funds through Counterparties

The counterparties of hedge funds are mostly banks. For practical reasons, most jurisdictions manage the systemic risk posed by hedge funds in an indirect manner through their supervision of banks, in particular, by ensuring that the latter have implemented proper risk management

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[63] Scotiabank, "Scotia Capital Announces Global Launch of Its Canadian Hedge Fund Performance Index", News Release, March 1, 2006.
[64] Financial Stability Forum, Report of the Working Group on Highly Leveraged Institutions, April 5, 2000.
[65] Financial Stability Forum, The FSF Recommendations and Concerns Raised by Highly Leveraged Institutions: An Assessment, March 12, 2002.

systems. Banks manage their exposure through appropriate collateral and margining requirements and by avoiding undue concentration of their business in a small number of very large clients.

b) The Canadian Situation

In Canada, banks are regulated by the Office of the Superintendent of Financial Institutions ("OSFI"), with the Bank of Canada as lender of last resort. The view is that the systemic risk posed by hedge funds in Canada is small because banks are adequately assessing the risk in their hedge fund exposure:

> "… I don't lose sleep over the growth of derivatives per se, or the increased involvement of hedge funds in the market."[67]

The view has also been expressed that, given the small size of the Canadian hedge fund industry, the exposure of counterparties to Canadian hedge funds is small:

> "This industry does not currently appear to be raising any concerns in matters of financial stability, especially since it is still small."[68]

We emphasize that the maintenance of effective risk management practices is a never-ending process. A satisfactory situation at one point in time is no guarantee that the situation will be equally satisfactory in the future. For instance, a bank may be tempted to relax its discipline in order to gain, or simply to maintain, market share in its prime brokerage business.[69] This indicates the necessity for continued assessment by banks of their hedge fund exposure and continued vigilance on the part of the regulatory authorities.

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[66] See Appendix I for an explanation of convertible arbitrage.

[67] Remarks by Nicholas Le Pan, Superintendent, Office of the Superintendent of Financial Institutions, to the Ottawa Economics Association, April 12, 2005.

[68] Miville Tremblay, "Portrait of the Canadian Hedge Fund Industry", *Bank of Canada Financial System Review*, December 2004.

[69] See Financial Services Authority, Financial Risk Outlook, 2006: "The risk is that competition could take the form of a relaxation of collateral and margin requirements, or that investment banks could be reluctant to make margin calls on lucrative clients for fear that it could lead them to take their businesses to another broker."

<u>Recommendation #1:</u> To manage systemic risk, Canadian regulatory authorities should show continued vigilance in ensuring that banks are continuously assessing their hedge fund exposure.

Going forward, the Basel II framework provides for the differentiation of capital requirements on the basis of risk. As Basel II is implemented in the next few years, it will be possible to relate more effectively the regulatory capital of banks to their hedge fund exposure. [70]

c) The Need for Information Exchange with Foreign Regulators

In addition to their direct exposure, Canadian banks face indirect exposure to hedge funds. The indirect exposure lies mainly outside Canada. If a major non-Canadian hedge fund were to fail, dragging one or more non-Canadian banks in its wake, this might have an indirect impact on Canadian banks with exposure to these non-Canadian banks. There is little that Canadian regulators can do about non-Canadian hedge funds except exchange information with foreign regulators. This can be done on a bilateral basis as well as through multilateral fora such as the FSF.

<u>Recommendation #2</u>: To keep track of the indirect exposure of Canadian banks to hedge funds, Canadian regulators should continue exchanging information with their foreign counterparts both on a bilateral basis and on multilateral fora such as the Financial Stability Forum.

The FSF was set up in April 1999 at the initiative of the G7 finance ministers and central bank governors. Its purpose is to promote international financial stability through enhanced information exchange and international cooperation in the supervision and surveillance of financial markets. It brings together senior officials of the central banks, supervisory authorities, and finance ministries of major economies as well as international organizations. Canada is represented on the FSF by the Department of Finance, the Bank of Canada, and OSFI.

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[70] European Central Bank, "Hedge Funds: Developments and Policy Implications", *Monthly Bulletin*, January 2006.

ii) Crown Corporations and Principal-Protected Notes

We noted in section 5(ii)(c) that Crown corporations are among the issuers of principal-protected notes. Crown corporations are willing to lend their name and credibility to principal-protected notes because it lowers their cost of borrowing. The savings are effectively funded by the retail investors who buy the principal-protected notes. This strategy is common among government agencies worldwide.

A report recently prepared for the Department of Finance made the point that funding through retail-oriented structured products raises issues of public policy and reputational risk.[71] Concerns include:

- Do retail investors understand the role of the Crown corporation in the transaction?
- If retail investors ultimately receive no return on their investment, will the reputation of Canada's credit suffer?
- Do the Crown corporations fully understand the issues?
- Given that the implementation of structured products requires complex swaps with counterparties with a lower credit rating than that of the Crown corporations, do the latter appropriately price the structural and counterparty risk?

The report further noted that, unlike their agencies, sovereign borrowers, including the Government of Canada, tend to find structured products unsuitable because of their complexity, lack of transparency, and understandability, and the reputational risk in the event of underperformance of these products. Furthermore, the management of structured products adds complexity to debt management strategies.

As an alternative to the existing borrowing framework, the report examined a framework of full centralization, where one centralized funding entity would borrow on behalf of both the Government and the Crown corporations. The report recommended that, if the current borrowing framework is maintained, guidelines should be established as to the types of structured note that are appropriate for Crown corporations, the manner of reporting the risk-adjusted cost of capital,

[71] KPMG, Review of Borrowing Framework of Major Federal Government-Backed Entities, June 15, 2005.

and the minimum risk management strategies associated with permitted products. We support these recommendations.

<u>Recommendation #3</u>: If the current borrowing framework for Crown corporations is maintained, guidelines should be established as to the types of structured note that are appropriate for Crown corporations.

7. <u>Investor Protection Issues</u>

Principal-protected notes are built on funds of hedge funds that are themselves built on stand-alone hedge funds. In our discussion of issues, we shall start at the bottom and work our way up.

The issues are cumulative in nature. Any issue affecting stand-alone hedge funds also affects funds of hedge funds, and any issue affecting the latter also affects principal-protected notes.

Rather than discuss hedge fund issues at large, we have decided to focus on those issues that are most relevant to the Canadian market place. Wherever possible, we give specific examples to illustrate our concerns.

In order to help understand the issues, we compare and contrast, where appropriate, hedge funds with mutual funds.

i. Stand-Alone Hedge Funds

a) Valuation Concerns

The main concern as regards stand-alone hedge funds relates to the valuation of the fund's assets.

"Inherent" Conflict of Interest

The manager of a hedge fund is responsible for valuing its assets. It also earns a performance fee, which depends upon the increase in value of the assets. SEC staff was sufficiently perturbed by this situation to describe it as an "inherent" conflict of interest.[72]

Managers' Ability to Value Hedge Fund Assets

Certain hedge funds invest in investments that are illiquid, lack external pricing sources, or are otherwise difficult to value. Globally, approximately 20 per cent of hedge fund assets are within

[72] See section 4(i)(b) above.

hard-to-value strategies.[73] In Canada, the corresponding percentage is likely to be lower because of the greater use of long/short equity, which is a relatively liquid investment strategy.

The question arises whether hedge fund managers have the systems and resources to value these investments adequately. This is how a practitioner described the typical Canadian hedge fund manager:

> "The typical operation includes one or two portfolio managers, one or two analysts, in-house accounting/chief financial officer, and some back-office support for the larger funds."[74]

In other words, the typical operation is small. From an investment perspective, there are definite advantages in being small and nimble. However, from an accounting perspective, it may be more difficult to set up a proper system of internal control in a small business. An internal control system, including segregation of duties and the independent checking of one person's work by another, is a protection against error.

We are aware that many hedge funds outsource the pricing of their portfolio. This does not fully address the concern because the service provider will normally seek the manager's advice in the case of hard-to-value assets.

The point has also been made that hedge fund managers do not have the optimal skill set or incentives to set up an effective control infrastructure.[75] This is because the principals of hedge fund managers often have an investment, rather than a business management, background.

b) Manager Failure

Errors in the valuation of the fund's assets are an example of operational risk. The ultimate operational risk is that of the manager's failure. In the recent past, there have been a number of cases in Canada where either the manager failed or the securities commissions found it necessary

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[73] Alternative Investment Management Association, Asset Pricing and Fund Valuation Practices in the Hedge Fund Industry, April 2005.

[74] Tom Schenkel, "Canadian Alternative Investment Management", *AIMA Journal*, April 2005.

[75] See for instance the FSA consultation paper discussed in section 4(ii)(a) above.

to intervene. These instances involved two hedge fund managers[76], a handful of mutual fund managers,[77] and a labour-sponsored fund manager[78].

Causes of Manager Failure

Certain broad conclusions may be drawn from these failures. In certain cases, the principals of the manager were not fit and proper persons. This is confirmed by the findings of the Commission des valeurs mobilières du Québec in the TIP case:

> "Those responsible for the administration of other persons' property and the managers and promoters of public issuers are subject to rigorous standards of conduct that neither Mr. Gagné nor Conseillers TIP was able to meet… Conseillers TIP and Paul Gagné do not have the competence and probity required by s. 151 of the Act to ensure the protection of investors."[79] (translation ours)

The Commission could scarcely have expressed itself more explicitly. We would add that fit and proper principals are probably the best form of defence against the manager's failure.

In some cases, inadequate capitalization of the manager contributed to the failure. Various symptoms of inadequate capitalization are apparent in the cases concerned: with the use of the assets of the fund to pay for the manager's expenses, improper billing of fees by the manager to the fund and, possibly, outright misappropriation of the fund's assets by the manager.

The lack of internal control was a contributory factor. In some cases, the managers were small operations run by a single individual and there was little scope for internal control. In other cases where it might have been possible to set up an internal control system, too much power was allowed to be concentrated in the hands of a single individual.

Regulations prohibit the manager of a publicly offered mutual fund from also being the custodian and require the custodian of the assets to be a bank, a trust company with a prescribed minimum

[76] Portus and Norshield.
[77] TIP, Excellence, Norbourg, Zenith and Argentum.
[78] Crocus.
[79] Commission des valeurs mobilières du Québec, Décision n° 2004-C-0052, Dans l'affaire de Conseillers de Placements TIP Ltée et Paul Gagné.

equity, or a subsidiary of either with a prescribed minimum equity.[80] An independent custodian dealing at arm's-length with the manager is a valuable internal control feature. In the case of hedge funds, there is nothing to prevent the manager or an affiliate from also being the custodian. However, in practice, the custody of the securities is often entrusted to the prime broker.

The failure of a fund manager undermines public confidence in the system. This may cause investors to turn away from investment funds as a vehicle for their long-term savings. In addition, manager failure is extremely detrimental to investors because it often leads to the liquidation of the funds and financial loss for the investors.

ii. Funds of Hedge Funds

Funds of hedge funds are subject to all the concerns relating to stand-alone hedge funds. In addition, they give rise to certain issues of their own.

a) Valuation Concerns

Here, too, valuation is a major concern but from a different angle.

In the United States, a registered investment company must, under the Investment Company Act of 1940, value its portfolio securities using market quotations or, if market quotations are not readily available, fair value as determined in good faith by the company's board of directors.

The corresponding Canadian legislation does not go into detailed rules. Instead, it enshrines the principle that the manager of a mutual fund has a duty of care in the performance of its office.[81]

Regulatory instruments and industry recommendations have expanded on the statutory requirement. NI 81-106 specifies that the net asset value of an investment fund must be calculated in accordance with Canadian GAAP. Additionally, the mutual fund industry, through the

[80] See Part 6 of NI 81-102.
[81] See, for instance, s. 116 of the Securities Act (Ontario).

Investment Funds Institute of Canada ("IFIC"), has developed recommendations on the practical application of fair value pricing.[82]

Here is an excerpt from the summary of significant accounting policies of a family of Canadian funds of hedge funds. The funds are sold in the exempt market. In addition, some serve as the underlying funds for principal-protected notes:

> "The value of any investments in hedge funds (the "Underlying Funds") is recorded at the net asset value of the Underlying Fund as provided by the administrator or manager of that Underlying Fund."

It would be legitimate to question whether the manager of the fund of hedge funds was properly fulfilling its statutory duty of care by accepting the values provided by the administrators or managers of the underlying funds. Arguably, it should have taken steps to satisfy itself independently that the values of the underlying funds were fairly stated.

We are aware that certain managers of underlying funds are reluctant to provide full transparency of their positions to investors. Some industry players have found a way to deal with this issue by subjecting the underlying fund to a quarterly audit by an independent auditor. This provides the manager of the fund of funds with some degree of comfort that the assets of the underlying fund are fairly stated.

b) Performance Fees Without Performance

Some managers of funds of hedge funds have found a way to charge performance fees even when the fund is losing money. They do this by calculating the performance fees on the basis of the performance of each underlying fund rather than of the overall performance of the fund of funds. Thus, even if the fund of funds is losing money overall, the manager will earn performance fees so long as at least one underlying fund is making money.

We believe that it is inappropriate for the manager of a fund of funds to earn performance fees when its investors are losing money.

[82] Investment Funds Institute of Canada, Bulletin No. 23: Fair Valuing Portfolio Securities, March 2002.

c) Non-Standard Management Expense Ratios

The most useful measure of the cost of an investment fund is probably the management expense ratio ("MER"), which expresses the total expenses of a fund as an annualized percentage of the daily average net asset value.

NI 81-102 has long prescribed a standard method of calculation of the MER for publicly offered mutual funds only. Since June 1, 2005, the method of calculation has been prescribed by NI 81-106 and its application extends to all investment funds, including closed-end funds, which are reporting issuers.

The prescribed MER includes all the fees (including performance fees) charged by the manager, operating expenses, and the Goods and Services tax ("GST").[83] Operating expenses include, among other things, audit fees, directors' or trustees' fees, the custodian's fees, legal fees, and the cost of printing and mailing financial statements to the security holders. The GST is an expense because supplies of financial services are generally exempt for GST purposes. This means that investment funds cannot recover the GST that they pay on the goods and services that they purchase.

The fees and expenses of a fund are invisible to the investor because they are usually deducted directly from the fund's assets and do not require the investor to write a cheque to anybody. Nevertheless, they are very real and reduce the investor's return.

Here is an excerpt from the annual report of a closed-end fund of hedge funds. The fund is listed on an exchange.

> "The management expense ratio ("MER") is the ratio of expenses to average net assets. The MER for the year ended December 31, 2004 was 3.15 per cent, before

[83] Brokerage commissions and other transaction costs on the purchase of securities by a fund are capitalised as part of the cost of the securities. Similar costs on the sale of securities are deducted from the gross sales proceeds. Thus, they do not form part of the MER but they do affect the fund's disclosed return. NI 81-106 requires the disclosure of a "trading expense ratio" by investment funds which are reporting issuers. This ratio expresses total commissions and transactions costs as an annualised percentage of daily average net assets and usefully complements the MER.

> GST. As is standard industry practice, this MER does not include the incentive fee of $2,309,738 paid for the year ended December 31, 2004."

We do not understand why performance fees have been excluded, considering that they are an explicit component of the manager's remuneration and are paid out of the fund's assets. We also note that "standard industry practice" is no longer considered to be a source of GAAP.

It may be argued that, if performance fees are included, the investor may be misled into thinking that the MER will continue at the same level in years when the fund's performance is not good. The answer is, there is nothing to prevent the manager from providing the necessary explanation to avoid the investor being misled.

The disclosed MER of 3.15 per cent is possibly misleading when compared by an investor with that of other publicly distributed investment funds.[84] We have calculated that the performance fees represent another 3 per cent of average net assets. This means that the fund's MER is actually 6.15 per cent plus GST, or 6.58 per cent. This is more than twice the disclosed MER.

NI 81-106, which came into effect on June 1, 2005, extends the prescribed method of MER calculation to all investment funds, including closed-end funds, which are reporting issuers. This should take care of the problem, at least for the closed-end fund in question.

d) Absence of Jurisdiction over Foreign Underlying Funds

We noted earlier that more than 90 per cent of the assets of Canadian funds of hedge funds are invested in underlying U.S.-based hedge funds.[85] It is advantageous to the Canadian investor to be able to access the broadest range of investment strategies and the best managers, wherever they may be found.

The United States has one of the most robust securities regulatory frameworks in the world. As a means of strengthening its oversight over hedge funds, the SEC has recently required most hedge

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[84] We realize that, in respect of the year ended December 31, 2004, closed-end funds were not subject to a standard method of MER calculation.

[85] See section 5.2.2 above.

fund advisers in the United States to register with it. These advisers will be subject to the SEC's examination program.[86][Change to section 4(a)(I)]

The concern is that there is nothing to prevent Canadian funds of hedge funds from investing in underlying funds located in jurisdictions with a weak regulatory framework. This could place Canadian investors at undue risk.

iii. Principal-Protected Notes

Principal-protected notes are subject to all the concerns we have raised in connection with stand-alone hedge funds and funds of hedge funds. In addition, they give rise to concerns of their own.

a) Form over Substance

Principal-protected notes are distributed under an exemption that applies to the debt instruments of certain entities.[87] Although principal-protected notes take the form of a debt instrument of a bank or a Crown corporation, in substance they are hedge funds because their return is linked to that of an underlying fund of hedge funds, net of fees and expenses. Principal-protected notes are thus regulated according to their form (i.e., a debt instrument) and not their substance (i.e., a hedge fund).[88]

In order to protect retail investors, publicly offered mutual funds are subject to strong regulatory safeguards. These include:

- Disclosure of all factors necessary to decide whether to invest or remain invested in the fund, such as the risks and costs involved, including the remuneration of the manager and the intermediary, and the ongoing performance of the fund;[89]
- Standard methods for computing performance data and management expense ratios;[90]

[86] See section 4(i)(a) above.
[87] See section 5(v)(e) above.
[88] A commentator pointed out to us that the "form versus substance" issue parallels the "rules versus principles" issue. Form is related to rules whereas substance is related to principles.
[89] NI 81-101 prescribes the contents of the simplified prospectus and the annual information form to be filed by all publicly offered mutual funds, whereas NI 81-106 prescribes the continuous disclosure requirements.

- Specified procedures for the operation of the fund;[91]
- Constraints on the manner in which the manager may charge performance fees;[92]
- Very strict constraints on sales practices, including the forms of monetary and non-monetary compensation that the manager may pay to the intermediary;[93] and
- A framework for the management of conflicts of interest (in the near future).[94]

Investors in principal-protected notes enjoy none of these regulatory protections because the underlying fund is privately distributed and the wrapper is treated as an exempt debt instrument.

The regulation of principal-protected notes is actually a special case of the more general problem of how to regulate wrapper products. Structured products such as principal-protected notes are one type of wrapper product. They use derivatives to transform the appearance of an investment product beyond recognition while essentially preserving its risk and return characteristics, net of fees.

Life insurance policies may also be used as wrappers in a manner similar to structured products. Although segregated funds and universal life insurance policies are investment vehicles, they are wrapped within life insurance policies and are regulated as such.

To the extent that the wrapper product is more lightly regulated than the underlying product, this opens the way to regulatory arbitrage. [95]

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[90] The methods of computation of performance data and the management expense ratios of publicly offered mutual funds are contained in NI 81-102 and NI 81-106 respectively.
[91] These procedures are contained in NI 81-102.
[92] These constraints are specified by NI 81-102 and NI 81-104.
[93] Mutual fund sales practices are regulated by NI 81-105.
[94] This will be covered by the proposed National Instrument 81-107 *Independent Review Committee for Investment Funds* ("NI 81-107").
[95] Here is another example of the use of structured products, this time in an institutional context. Suppose a pension fund wants to be exposed to hedge fund strategies but does not wish to invest directly in hedge funds. This may be because it is not allowed to do so or because it wants to avoid the reputation risk of being associated with hedge funds. The pension fund can achieve its objective by investing in a structured product which wraps a politically correct instrument, such as a bond, around a hedge fund. This approach is used in certain European countries where pension funds are not allowed to invest in hedge funds directly. See Stanley Fink, "The Distribution of Hedge Funds to Mass Affluent Investors", *AIMA Journal*, September 2005.

b) Protection Structures Benefit the Guarantor, Not the Investor

As discussed above, principal-protected notes normally include a mechanism or structure to reduce the risk involved in providing the principal guarantee.[96] These structures are set up by the guarantor and are meant for its protection, not that of the investor. It would seem that many investors do not understand this. In the course of our research, we found that many persons were under the impression that these structures enhanced investors' protection. In actual fact, investors are totally dependent on the creditworthiness of the guarantor for the repayment of their principal. In a worst-case scenario, which is the bankruptcy of the guarantor, note holders will rank as unsecured creditors and will not have preferential access to the investments held in the structure.

c) How Necessary Is the Principal Protection?

As their name implies, the principal of principal-protected notes is guaranteed, provided they are held until maturity. From an investment perspective, there is an inherent contradiction in providing a principal guarantee on a fund of hedge funds. Hedge funds aim at generating absolute returns and preserving capital. This is even more so in the case of funds of hedge funds because they are diversified by investment strategy and manager. The long period to maturity of principal-protected products (seven years or more) further reduces the risk of loss.

For the above reasons, the capital guarantee is arguably not necessary except for conservative investors.[97]

d) How Solid Is the Capital Protection?

The quality of the principal protection varies with the financial strength of the issuer. In principle, it is fairly easy to assess the financial strength of an issuer. This may be done by looking at the credit rating of its debt instruments.[98] Lenders expect a higher rate of interest from issuers with lower credit ratings in order to compensate for the higher risk of default. In the case of principal-

[96] See section 5(ii)(c).
[97] One commentator described buyers of principal-protected notes as wearing both belts and suspenders. We could not resist the temptation to quote this colourful piece of imagery.
[98] The credit ratings of issuers of principal-protected notes typically range from "AAA" (where the issuer is a Crown corporation) to "A".

protected notes, it is difficult for investors to assess whether the expected returns from different investments adequately reflect the differences in the credit rating of the issuers.

The credit rating of the issuer is also relevant because principal-protected notes are not covered by deposit insurance. In the event of the failure of an issuer, the holders of its Guaranteed Investment Certificates would be compensated up to the ceiling of $100,000 per account. Holders of principal-protected notes would have no such luck.

We would also point out that the exemption under which principal-protected notes are distributed to retail investors does not apply only to the debt instruments of government and banks. It extends to the debt instruments of a rather long list of issuers whose credit worthiness probably varies greatly.

e) How Much Does the Product Cost?

The manager of a principal-protected note has voluntarily disclosed in the product documentation that the estimated fees and expenses of its product amount to 4.5 per cent of assets per annum plus performance fees equal to 20 per cent of profits. These figures include the fees of the managers of the underlying hedge funds and the fund of hedge funds, sales commissions and trailer fees to intermediaries, guarantee and swap costs, and estimated fund administration costs.

Let us assume a not unreasonable annual gross return of 10 per cent. In this case, the fees and expenses will amount to 6.5 per cent, leaving only 3.5 per cent for the investor. If we assume a more aggressive annual return of 15 per cent, the fees and expenses will amount to 7.5 per cent, leaving 7.5 per cent for the investor. It is a cause for concern when 50 per cent or more of the gross return on an investment product is consumed by fees and expenses.

There are actually far worse cases. The product we have just described is one of the cheapest principal-protected notes available. This is the case because the underlying fund of funds invests in stand-alone funds managed by the same manager and the latter collects management and performance fees only once.

f) Disclosure

There are disclosure issues at all three levels. However, in order not to repeat ourselves, we chose to discuss these issues here.

The Quality of Disclosure Varies

Our main concern is that, because the contents of offering memoranda and information statements are not prescribed, the quality of disclosure varies. In some cases, it may not be adequate to enable the investor to assess properly the risk-return characteristics of the investment and to decide whether it fits within his investment objectives.

The Full Cost of the Investment Is Not Always Clear

We are also concerned that the investor may not understand the full cost of owning the investment. Disclosure of standard management expense ratios is not mandatory, except in the case of investment funds that are reporting issuers. This excludes principal-protected notes.

Intermediaries' Remuneration Is Not Always Transparent

We believe that total transparency of intermediaries' remuneration is essential for a relationship of trust to prevail between the intermediary and its client. Some information statements are deficient in this respect.

The manager of a principal-protected note has disclosed in the information statement that, in addition to management fees not exceeding 4 per cent of assets per annum and performance fees of approximately 22.5 per cent of profits, the fund will be subject to a "flat" fee of 6 per cent of assets per annum which will cover, among other things, the remuneration of intermediaries. The amount of intermediaries' remuneration is not disclosed. Instead, we find this statement:

> "Detailed information concerning agency fees that would be payable by a particular investor can be obtained from brokers, financial planners and other investment professionals who are members of the Selling Group."

We believe that the remuneration of intermediaries should be clearly and explicitly disclosed in the information statement.[99]

g) Suitability for Investors

Intermediaries are responsible for ensuring the suitability of all investments that they sell to a client. This is as it should be.

We discussed earlier the sometimes egregious compensation paid to intermediaries that sell principal-protected notes. The question arises whether the intermediary's compensation sometimes takes precedence over the suitability of the investment for the client.

In a speech to the Toronto Chartered Financial Analysts Society, the former Chair of the OSC commented on the failure of the hedge fund manager Portus. He noted that approximately $750 million worth of Portus' products had been sold to a broad investor base of 26,000 retail investors. That was not a case of early investment successes fuelling explosive demand, and the promoter was a relatively unknown individual, with no proven track record and no market reputation. So what could have accounted for the tremendous sales record?

> "Perhaps there is only one particular feature to speak of—high up front fees and trailer fees for referrals. The potential earnings for agents were high."[100]

We can corroborate that the attractive remuneration paid to intermediaries by certain managers of principal-protected notes has contributed to the rapid growth of this product.[101]

h) Impact of Inadequate Disclosure on Intermediaries' Remuneration

Some industry observers have pointed out to us that there is a direct causal link between the lack of a requirement to disclose intermediaries' remuneration and the level of such remuneration. We

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[99] Contrast this with publicly offered mutual funds which are required by NI 81-101 to disclose in the simplified prospectus both the nature of dealer compensation, e.g., upfront sales commission and trailing commissions, and the range of the rates of commissions.
[100] Remarks by David A. Brown, Q.C., Chair, Ontario Securities Commission, to the Toronto CFA Society, May 10, 2005.

believe that managers would be more restrained in their use of intermediaries' remuneration as a competitive tool if they were required to disclose such remuneration clearly and explicitly in the information statement.

[101] We are aware that Portus' products were not strictly principal-protected notes.

8. A Canadian Framework

i) What Need for Regulation?

A recurring theme throughout this report is that hedge funds have the potential to improve the efficiency of a portfolio. By adding hedge funds to a portfolio of stocks and bonds, it is possible to obtain the same expected return with less risk. High net worth investors understood this phenomenon a long time ago. In the wake of the bear market of 2000 to 2002, institutional investors have also increased their allocation to hedge funds. Retail investors currently constitute the only group without proper access to hedge fund strategies.

There is at present no securities regulatory framework in Canada for retail hedge funds.[102] We believe that this situation is not ideal for two main reasons. First, it has prevented retail investors from having direct, efficient access to legitimate investment strategies, which can improve the risk-return trade-off of their portfolio. Second, it has allowed principal-protected notes to become the mainstream retail hedge fund vehicle when their proper role should be that of a specialty product for a limited market segment.

a) Indirect Access to Hedge Funds Is Inefficient and Costly

We may analogise principal-protected notes with the RRSP clone funds that existed prior to the abolition of the foreign-property rule. Clone funds were devised in order to enable registered investment accounts to do indirectly what they could not do directly i.e., gain exposure to foreign markets over and above the 30 per cent limit allowed by the foreign-property rule.

Circuitousness has its drawbacks. In the case of the clone funds, the drawbacks were the cost of the derivatives used to gain indirect exposure to foreign markets as well as the cost associated with managing, operating and marketing the clone fund. Clone funds were always recognized as an inefficient way to gain exposure to foreign markets. When the foreign-property rule was abolished in 2005, clone funds became redundant because their inefficiency could no longer be justified. Most have since been merged with the underlying funds whose return they were trying

[102] Excepting the prospectus-based system and NI 81-104.

to replicate, net of fees and expenses. Investors have benefited from the elimination of the additional costs associated with clone funds.

Similarly, principal-protected notes were devised in order to enable retail investors to gain indirect exposure to hedge fund strategies. Here, the obstacle was not a rule such as the foreign-property rule. Rather, it was an absence of rules. To be precise, the obstacle was the absence of a regulatory framework for retail hedge funds. This made it impossible to offer hedge funds directly to retail investors.

Nature abhors a vacuum. It is a characteristic of a dynamic, innovative capital market that it will move quickly to seize a perceived opportunity. In this case, the solution that the market devised was to wrap a debt instrument of a bank or a Crown corporation around a fund of hedge funds and take advantage of an exemption provided by securities legislation to distribute the product widely.

Again, this roundabout way of doing things has its costs. Additional layers of fees and expenses, as explained in section 5(vi), are necessary to remunerate the issuer and the guarantor of the principal-protected note. All purchasers of principal-protected notes have to pay for the capital guarantee even though most of them probably do not require it. In addition, investors do not benefit from regulatory protections such as those described in section 7(iii)(a).

The solution is to remove the obstacle that gave rise to the inefficient product. In this case, removal of the obstacle means putting in place appropriate protections in the form of a regulatory framework for retail hedge funds that would allow retail investors to gain direct exposure to hedge fund strategies. We have been told by managers of principal-protected notes that, if they could offer hedge funds directly to retail investors, they would do so rather than go the indirect route.

There is no compelling reason why hedge funds should not be able to offer their securities to the public if they are willing to submit to requirements on prospectus and continuous disclosure, operational and sales practices, and the management of conflicts of interest. A number of jurisdictions outside of North America have already crossed that bridge.

We believe that markets should be allowed to function as freely as possible and that there should be regulatory intervention only when this is clearly necessary and when the benefits of regulation outweigh the costs. It seems to us that this is one of those cases where regulatory intervention is warranted.

b) How a Specialty Product Became a Mainstream Product

If a retail investor wishes to buy, say, an index fund, it is easy to do so directly. This will give the investor exposure to the risks, including the risk of loss, and the full potential returns of the investment. If the investor is conservative and desires protection against the loss of the principal, the investor may buy a structured product that uses the index fund as the underlying investment and provides a principal guarantee. In exchange for the principal guarantee, the investor will incur costs, in the form of higher fees and a possible cap on returns, and enjoy less regulatory protection. It will be open to the investor to weigh the pros and cons and decide which investment is better in the circumstances.

Contrast this situation with that of principal-protected notes linked to hedge funds. A retail investor who wishes to buy a hedge fund cannot do so directly. The best he can do is to invest indirectly through a principal-protected note. The absence of alternatives has allowed principal-protected notes to become the mainstream retail hedge fund vehicle when their proper role should be that of a specialty product for conservative investors.[103]

c) Benefits to the Retail Investor

Regulation implies costs but it also brings benefits. By gaining direct, efficient access to absolute return strategies, retail investors will be able to improve the efficiency of their investment portfolio while at the same time benefiting from cost savings.

[103] There do exist structured products whose return is linked to that of a fund of hedge funds and whose principal is not protected. These products suffer from being an indirect, and therefore more costly, mode of access to hedge funds.

d) Benefits to the Industry

An excellent example of the benefits of regulation is to be found in the mutual fund industry. Mutual funds have democratized the world of investing. Thanks to this investment vehicle, retail investors are able to enjoy portfolio diversification and professional management that would otherwise be available only to institutional and high net worth investors.

From a modest base at the beginning of the1990s, mutual fund assets in Canada have grown to exceed $500 billion. This phenomenal growth is due to a number of factors, including favourable demographics. We believe that the presence of a strong regulatory regime has also played a role. While the mutual fund regime is far from perfect, the protection it affords to investors has legitimized mutual funds as an investment vehicle and created the necessary sense of security for investors to trust the product.

The industry itself has developed mechanisms to complement the regulatory framework. There is now a large body of mutual fund analysts who weigh the merits of individual mutual funds and serve as a source of unbiased information to investors. Mutual fund ratings such as those provided by Morningstar play a similar role.[104]

A strong but appropriate regulatory framework for retail hedge funds could provide a similar impetus to the hedge fund industry. Indeed, certain industry participants recognize that the benefits of regulating hedge funds exceed the costs:

> "As growth in the Canadian hedge fund industry continues, we will see increased media attention and scrutiny. For some time, we have stated that increasing regulatory oversight of hedge funds will be of benefit to the industry."[105]

[104] The objectivity of analysts is a topical subject. Mutual fund analysts are employed by investment dealers, mutual fund dealers and rating organisations such as Morningstar. Investment dealers have other business relationships, such as securities trading, with mutual fund managers. The point is sometimes made that multiple business relationships can be a threat to objectivity.

[105] BluMont Capital Inc, Quarterly Report, June 30, 2005.

ii) Funds of Funds Only, or Stand-Alone Funds Too?

An important question to be addressed is whether retail investors should have access only to funds of funds (including multi-adviser funds) or to stand-alone funds as well.[106]

A mutual fund is a diversified portfolio in itself. This is certainly the case for mutual funds that invest in several asset classes. Even mutual funds specializing in a single asset class such as equity or fixed income provide a degree of diversification because their assets are invested in a number of securities. Since it is unlikely that all the securities will fail at once, it is rare for a mutual fund investor to lose all his money.

Unlike a mutual fund, a stand-alone hedge fund is not a diversified portfolio in itself. An investment in a stand-alone hedge fund is effectively an investment in the adviser's skill at applying a given strategy. When investing in a stand-alone hedge fund, there is a real risk that the investor may lose all his money.

In order to achieve diversification with hedge funds, it is necessary to use funds of hedge funds. By design, funds of hedge funds are diversified by investment strategy and by adviser. In addition, the underlying funds and their respective advisers have undergone a due diligence exercise on the part of the fund of funds manager, and their performance as well as their adherence to the stated investment strategy are constantly monitored.

For these reasons, we recommend that retail investors should have access only to funds of hedge funds (including multi-adviser funds) but not to stand-alone hedge funds. Given the relative safety of funds of hedge funds, we recommend that there should not be a minimum purchase amount.

Recommendation #4: Retail investors should be allowed to invest directly in funds of hedge funds, including multi-adviser funds.

Recommendation #5: Retail investors should not have access to stand-alone hedge funds.

[106] See section 5(ii)(b) for a description of multi-adviser funds.

<u>Recommendation #6</u>: Purchases of retail funds of hedge funds should not be subject to a minimum purchase amount.

It goes without saying that the opening of retail markets to funds of hedge funds should be accompanied by initiatives to educate the investor on the subject of alternative investing. Regulatory authorities and industry associations can play a useful role in this regard. We believe that investor education on this subject should emphasize the benefits of diversification, the differences between traditional and alternative investing, and the way in which funds of hedge funds may contribute to improving a portfolio's diversification.

<u>Recommendation #7</u>: The opening of retail markets to funds of hedge funds should be accompanied by initiatives to educate the investor on the subject of alternative investing.

c) A Road Map

The rest of this section is structured as follows:

Section

8(iv)	A structural approach to the regulation of retail hedge funds.
8(v)	The qualifications of the manager.
8(vi)	The qualifications of the adviser.
8(vii)	The relationship between the intermediary and the investor, and the standards to be observed during the selling process.
8(viii)	Enforcement.
8(ix)	Our recommendations and the Task Force's terms of reference.

d) A Structural Approach

In its recent discussion paper on wider-range retail investment products, the FSA hit the nail right on the head when it recognized that a regulatory regime should work for managers; otherwise they will simply not use it.[107] With this overriding consideration in mind, what structural approach is likely to work best?

We believe that a regulatory framework for retail hedge funds is best integrated within the existing mutual fund framework. We noted in section 5(iv) that NI 81-104 constitutes an embryonic hedge fund framework. A possible way to implement our recommendations would be to update and modernise NI 81-104 to enable retail investors to invest in funds of hedge funds while benefiting from the protection of regulatory oversight.

<u>Recommendation #8</u>: The regulatory framework for retail funds of hedge funds should be integrated within the existing mutual fund framework. A possible way to implement our recommendations would be to update and modernize the existing NI 81-104.

Our recommended approach is consistent with IOSCO's analysis:

> "... it is useful to explore whether the principles embodied in the regulation of CIS[108] are relevant for the regulation of hedge funds (including funds-of-hedge-funds). It is argued here that this is the case and that, if jurisdictions are willing to permit retail investment in (funds-of-) hedge funds, it is not necessary, from a viewpoint of investor protection, to develop new approaches that significantly divert from those principles in order to accommodate hedge funds. The main objective of CIS-regulation, after all, is not to prevent the incurring of losses on investments, but to create a framework within which products are offered that are suitable for retail investors. This can be achieved by, among other things, ensuring that the risks involved are disclosed in such a fashion that they are understandable for retail investors."[109]

Table 4, which we have adapted from the IDA and AIMA Canada, shows the main differences between publicly offered mutual funds and pooled hedge funds i.e., privately offered hedge funds

[107] See section 4(ii)(a)
[108] Collective Investment Schemes.
[109] Technical Committee of the International Organization of Securities Commissions, Regulatory and Investor Protection Issues Arising from the Participation by Retail Issuers in (Funds-of) Hedge Funds, February 2003.

such as stand-alone hedge funds and funds of hedge funds.[110] It provides a guide to the matters to be addressed in carving a place for retail hedge funds within the mutual fund framework. Essentially, the challenge is to allow funds of funds to invest in underlying unregulated hedge funds, but as a countermeasure to add more stringent requirements on disclosure, the operation of the fund of funds, and the proficiency and experience requirements of the manager and adviser. But first, let us briefly overview the existing regulatory framework for mutual funds.

a) Overview of Existing Regulatory Framework for Mutual Funds

Canadian securities legislation generally defines mutual funds as investment funds that give investors the right to redeem securities on demand at a price based on their net asset value.[111] Mutual funds may or may not be reporting issuers.

Mutual funds are subject to general securities legislation. In addition, there are a number of regulatory instruments that apply specifically to mutual funds, which are reporting issuers.[112] The main existing instruments are:

- NI 81-101 *Mutual Fund Prospectus Disclosure*;
- NI 81-102 *Mutual Funds*;
- NI 81-104 *Commodity Pools*;
- NI 81-105 *Mutual Fund Sales Practices*; and
- NI 81-106 *Investment Fund Continuous Disclosure.*

[110] Investment Dealers Association of Canada, *op. cit* and Alternative Investment Management Association (Canadian chapter), AIMA Canada Hedge Fund Primer, 2004.
[111] See, for instance, s. 1(1) of the Securities Act (Ontario). In Québec, s. 5 of the Securities Act (Québec) defines a mutual fund as a "fund consisting of funds commingled under a collective investment contract managed on behalf of holders by a person who, on request, redeems the units at their net asset value".
[112] In certain provinces and territories, NI 81-106 also applies to mutual funds which are not reporting issuers.

Table 4[113]
Comparison Between Publicly Offered Mutual Funds and Pooled Hedge Funds

		Mutual Funds	**Pooled Funds**
1.	Regulation	Highly regulated	Less regulated
2.	Reporting issuer	Yes	No
3.	Structure	Trust Investment company	Trust Limited partnership Private trust
4.	Disclosure	High level of mandated disclosure and transparency	Less mandated disclosure
5.	Documentation	Prospectus	Offering memorandum
6.	Minimum purchase	Small	Large
7.	Investment by manager	Rare	Manager generally invests its own money in the fund
8.	Performance	Relative return measured against a benchmark index dependent on the performance of the market	Absolute return No benchmark index Expected to make a profit under all market conditions
9.	Investment strategy	Limited Take long-only positions No use of leverage	Flexible Long and short positions May use leverage
10.	Correlation with market	High	Low
11.	Reporting requirements	Annual audited, and semi-annual, financial statements must be filed and distributed to security holders No requirement to prepare a management report of fund performance	No requirement to file financial statements Must prepare a mgmt report of fund performance, including disclosure of the MER
12.	Net asset valuation	Daily	Weekly or monthly
13.	Derivatives	May use only in a limited way	May use in any way
14.	Custodian	Must be a bank, trust company or subsidiary of either	Fund manager may be the custodian
15.	Liquidity	Good	Liquidity restrictions Initial lock-up periods
16.	Settlement on FundSERV	Yes	Yes
17.	Fund manager compensation performance	Tied to assets under management	Tied primarily to
18.	Distribution	Investment dealers Discount brokers Mutual fund dealers	Investment dealers Limited market dealers
19.	Commission	Sales commission Asset-based trailer fee	Sales commission Asset-based trailer fee Share of performance fees

[113] Source: Adapted from IDA and AIMA Canada

NI 81-101 aims at ensuring that mutual funds disclose to investors information that they should consider when deciding whether to invest, or remain invested, in a fund. To this end, it prescribes the content of two key disclosure documents, namely, the simplified prospectus and the annual information form.

NI 81-102 is the main instrument regulating mutual funds. Among other points, it:

- sets out restrictions on the manner in which a mutual fund may invest its assets;
- provides a framework for funds of funds to invest in underlying mutual funds;
- prohibits the manager from acting as custodian of the fund and specifies that the custodian must be a bank, a trust company or a subsidiary of either;
- specifies how performance fees should be calculated;
- specifies procedures designed to ensure that investors' money is received promptly by the fund and to minimize the risk of loss of the money prior to it being invested in the fund; and
- prohibits misleading sales communications relating to a fund and provides a formula for calculating standard performance data.

We discussed NI 81-104 in section 5(iv) above.

NI 81-105 aims at ensuring that mutual funds are sold on the basis of what is suitable for, and in the best interests of, investors rather than on the basis of incentives received by dealers and their sales representatives. It sets minimum standards of conduct to be followed by managers, principal distributors, registered dealers, and the latter's sales representatives when distributing mutual funds. It prohibits the payment of any monetary or non-monetary compensation by the manager to dealers in connection with the distribution of the units or shares of a mutual fund, except for those forms of payment which are specifically allowed.

NI 81-106 has broader application than its predecessors. Its application extends to all investment funds that are reporting issuers, including non-redeemable investment funds such as closed-end funds and funds traded on exchanges with limited redemption privileges. Some sections also apply in certain provinces and territories to mutual funds that are not reporting issuers. NI 81-106 prescribes a continuous disclosure regime for the relevant entities. It sets out disclosure requirements in respect of financial statements, management reports of fund performance, quarterly portfolio disclosure, annual information forms, proxy voting, material changes, proxy solicitation, and information circulars.

In addition, there are two proposed or forthcoming National Instruments.

The proposed National Instrument 81-107 *Independent Review Committee for Investment Funds* will apply to all investment funds that are reporting issuers. It provides that such funds should have an Independent Review Committee ("IRC") to review all matters involving an actual or a perceived conflict between the manager's own interests and its duty to manage the funds in the best interest of the funds. Certain specified transactions and certain changes to a mutual fund would require prior approval of the IRC before being implemented. In the case of other transactions involving a conflict of interest, the IRC would have to provide the manager with a recommendation, which the manager would have to consider before proceeding.

The forthcoming National Instrument 81-108 *Compliance Programs for Investment Funds* is part of the regulatory response following the 2004 probe into mutual fund trading practices. It is understood that it will require investment funds to institute formal compliance programs.

Retail hedge funds would be subject to all the regulations described above with appropriate adjustments that we shall now try to identify.

b) Investment Strategies

Part 2 of NI 81-102 sets out a number of prohibitions and restrictions on the manner in which a mutual fund portfolio may be invested. Among others, it:

- limits portfolio concentration by preventing a mutual fund from generally holding more than 10 per cent of its net assets in the securities of an issuer; there are exceptions for index mutual funds and for funds of funds investing in underlying mutual funds to which NI 81-101 and NI 81-102 apply;
- prohibits a mutual fund from owning more than 10 per cent of the securities of an issuer;
- prohibits a mutual fund from investing in certain types of asset, such as gold, other than permitted gold certificates, and commodities;

- restricts the purchase of illiquid assets;
- prohibits the borrowing of cash, except for specified purposes, such as meeting redemption requests pending the sale of portfolio assets;
- prohibits the purchase of securities on margin, except in specified circumstances related to derivatives;
- prohibits the short selling of securities, except in specified circumstances related to derivatives;
- limits counterparty risk by restricting the types of derivative that may be purchased; and
- sets out rules for transacting in derivatives for non-hedging purposes.

Certain foreign jurisdictions require that retail funds of hedge funds hold a minimum number of underlying funds. This is to ensure that the funds of funds are appropriately diversified. We note that NI 81-102 already provides an adequate restriction on investment concentration. A mutual fund may generally not purchase a security of an issuer if this would result in its holding more than 10 per cent of its net assets at market value in securities of any issuer.

c) Underlying Funds

Part 2 of NI 81-102 prohibits a fund of funds from holding securities of an underlying fund unless both funds are qualified for distribution in the local jurisdiction.

A carve-out from this prohibition would be required to enable retail funds of hedge funds to invest in underlying hedge funds that are not qualified for distribution in the local jurisdiction. We understand that this is also the approach that the FSA has in mind for eventual retail funds of hedge funds in theUnited Kingdom.

<u>Recommendation #9</u>: Retail funds of hedge funds should be allowed to invest in underlying unregistered hedge funds.

Under the Investment Modernisation Act of 2004, retail funds of hedge funds in Germany are allowed to invest in *foreign* underlying funds that meet certain conditions, including:

- They must have investment policies comparable to those applicable to German stand-alone hedge funds;
- Their assets must be held by a custodian bank or comparable institution, such as a prime broker;
- They must be domiciled in jurisdictions that actively prohibit money laundering.

d) Performance Fees

Part 7 of NI 81-102 specifies how the manager of a mutual fund may charge performance fees. In particular, the fee must be calculated by reference to a benchmark or index, and must be based on a comparison of the performance of the mutual fund against that of the benchmark or index.

In sections 3(i) and 3(ii), we explained the difference between traditional investing, where the objective is to outperform a benchmark or index, and alternative investing, where the objective is to generate an absolute return irrespective of the market's conditions. Part 7 of NI 81-102 was evidently crafted with traditional investing in mind. It was not intended to accommodate alternative investing.

The manner of calculating performance fees would need to be amended to recognize the fact that hedge funds aim at absolute rather than relative returns. We note that NI 81-104 already allows managers of commodity pools to calculate performance fees without reference to an index. We would recommend that a high-water mark be made mandatory. We would also recommend that, since we are dealing with funds of funds, performance fees should be computed on the basis of the performance of the fund of funds as a whole and not that of each underlying fund.

Recommendation #10: Performance fees of retail funds of hedge funds should be subject to mandatory high-water marks, and be computed on the basis of the performance of the fund of funds as a whole and not that of each underlying fund.

e) Sharing of Performance Fees with Intermediaries

NI 81-105 prohibits the manager of a mutual fund from making any payment to a dealer in connection with the distribution of securities of the mutual fund, except for those payments that are specifically allowed.

The payment of trailer fees that are "based upon the aggregate value of securities of the mutual fund held in accounts of clients of the participating dealer as at a particular time or during a particular period" is allowed, provided various other conditions are met.

We noted earlier that some hedge fund managers pay to intermediaries a trailer, which is a portion, usually 10 per cent, of their performance fees. The issue here is whether the payment of these fees is likely to create a conflict of interest for intermediaries. Is there a risk that the latter might steer their clients to products that pay a portion of performance fees in addition to the asset-based trailer, even if these products are less suitable for the client than other products?

We note that NI 81-105 has been extremely successful at reducing, if not eliminating, conflicts of interest between intermediaries and their clients. We see no compelling reason for recommending a change.

<u>Recommendation #11</u>: Managers of retail funds of hedge funds should not be allowed to pay a portion of their performance fees to intermediaries in the form of trailer fees.

f) Redemption

Certain hedge fund assets may be illiquid. Hedge fund managers deal with this by imposing lock-up periods, limiting the frequency of redemptions and requiring notice periods prior to redemptions.

We note that NI 81-104 already allows a lock-up period of up to six months. It also allows the payment of the redemption price within 15 days after the date of calculation of the redemption price, as opposed to three business days for regular mutual funds.

It would be useful for the regulations to also specify a minimum frequency for redemptions, say at least once every month or quarter, and a maximum notice period.

<u>Recommendation #12</u>: The regulations should specify a maximum lock-up period, a minimum frequency for redemptions and a maximum notice period.

g) Independent Valuation of Fund Assets

Given the concerns on valuation, we recommend that the fund's assets should be valued not by the fund manager but by an independent third party. This could be the fund's administrator. We recognize that the fund manager will usually be more knowledgeable than the administrator and that the latter may turn to the manager for guidance. As noted by the FSA, this risk can only be mitigated and not entirely avoided.[114] We also note that the financial statements of the fund will be audited, which provides another layer of comfort.

<u>Recommendation #13</u>: The assets of retail funds should be valued not by the fund manager but by an independent third party such as the fund's administrator.

It is important for the funds of funds not to rely exclusively on the valuations provided by the managers of the underlying funds. They should be required to institute procedures to satisfy themselves independently that the underlying hedge funds are fairly valued. These procedures would cover matters such as:[115]

- A procedure for ascertaining the contents of the portfolios of the underlying funds on each valuation date;
- A procedure for collecting from independent sources up-to-date information necessary to value the assets; information would be required on factors such as securities prices, interest rates, exchange rates, and volatility[116];
- The establishment of procedures for valuing illiquid assets;
- The establishment of proper accounting policies; and

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[114] See section 4(ii)(a)
[115] See Monetary Authority of Singapore, Internal Controls, February 2006.
[116] Data on volatility would be required for valuing options.

- The approval by the board and senior management of periodic reports on the valuation of assets.

Recommendation #14: Retail funds of hedge funds should be required to institute procedures to satisfy themselves independently that the underlying hedge funds are fairly valued.

h) Side Letters

Certain hedge funds enter into side letters with certain investors whereby these investors are given special rights. Examples of these rights are:

- Lower management or performance fees;
- The right to be informed on the occurrence of specified events such as the departure of a principal of the manager, a redemption by a principal of the manager, or the start of regulatory proceedings against the fund or the manager;
- A right to redeem their investment ahead of other investors; such a right would be particularly useful on the occurrence of one of the events discussed above.

A basic principle is that all investors of the same class should be treated in the same way. Side letters give rise to concerns because they may result in investors of the same class not being treated equally. The disclosure of information to some investors but not to others is also a cause for concern.

Recommendation #15: Retail funds of hedge funds should be prohibited from entering into side letter agreements.

i) Disclosure

Investing is about achieving a trade-off between risk and return with which the investor is comfortable, given his degree of tolerance for risk and his investment objectives. An investment fund's disclosure should allow the investor to assess the risk-return trade-off.

NI 81-101 prescribes the contents of simplified prospectuses and annual information forms whereas NI 81-106 prescribes the continuous disclosure requirements. These instruments are robust. We note that commodity pools are subject to additional disclosures, notably relating to risk, and that they must use long-form rather than simplified prospectuses.

There are certain features peculiar to hedge funds that should be required to be disclosed within a retail hedge fund framework:

- All fees and compensation of the manager and intermediary, including the method of computation and the disclosure of the layers of fees and expenses involved in funds of funds; and
- All conflicts of interest.

<u>Recommendation #16:</u> Retail funds of hedge funds should be required to make full disclosure of all fees and compensation of the manager and the intermediary, and all conflicts of interest.

Outcome Based Disclosure

A recurring question is how best to disclose the risk of hedge funds or, for that matter, any type of investment in a way that is understandable by the retail investor.

We believe that, in order to be investor-friendly, disclosures should be short and to the point. This is more helpful than lengthy, complex disclosure that overwhelms the reader.

In its discussion paper on wider-range retail investment products, the FSA mused over the possibility of requiring the disclosure of the range of possible outcomes of an investment in a form understandable by the retail investor.[117] This would include disclosure of the potential for strongly negative outcomes. We believe that there is promise in this line of thought and recommend that managers of retail hedge funds and other investment funds should be encouraged to experiment with outcome-based disclosure. We believe that such disclosure should be supplementary to, rather than a substitute for, traditional forms of disclosure.

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[117] See section 4(ii)(a) above.

<u>Recommendation #17</u>: Investment fund managers should be encouraged to experiment with outcome-based disclosure. This should be supplementary to, rather than a substitute for, traditional forms of disclosure.

j) The Regulation of Principal-Protected Notes

If our recommendations are accepted, we expect that principal-protected notes will become a specialty product for those investors who want principal protection and are willing to bear the additional costs. In order to provide appropriate protection to these investors, we recommend that principal-protected notes should be regulated according to the nature of the underlying investment. In other words, they should be regulated according to substance rather than form.

<u>Recommendation #18</u>: Principal-protected notes linked to hedge funds should be subject to the same regulatory requirements, particularly as regards disclosure and sales practices, as retail hedge funds.

We believe that this recommendation properly addresses the cause rather than the symptoms of the problem. The drawbacks of regulatory measures that address symptoms rather than cause are well known:

> "Regulation … can address the symptoms or the cause of a problem. For example, an outright product ban or the creation of large barriers to the sale of a product might solve a particular consumer ill, albeit at the cost of reduced consumer choice. Nevertheless, failure to address the cause of that ill, which might be information or incentive problems, is likely to mean that a new product or service will soon create a similar detriment for consumers."[118]

e) Qualifications of the Manager

We mentioned earlier that hedge funds are subject to a number of operational risks, including incorrect valuation of the fund's assets and manager failure, which is the ultimate operational

[118] Isaac Alfon and Peter Andrews, Cost-Benefit Analysis in Financial Regulation, Occasional Paper No. 3, Financial Services Authority, September 1999.

risk. We noted that manager failure may cause hardship to the investors concerned and may erode confidence in the system. It would not be in Canada's interest if investors stopped investing in investment funds.

We noted that manager failure may be the result of the principals not being fit and proper persons, inadequate capitalisation of the manager or the lack of internal controls.[119]
We believe that the most appropriate way to manage these risks is through registration of fund managers.

<u>Recommendation #19</u>: Hedge fund managers should be required to register.

It should be noted that the objective is not to prevent manager failure at all costs. Rather, the objective is to put in place a system to identify problems in a timely manner so as to enable appropriate regulatory action to be taken before it is too late.

Our recommendation is consistent with the proposal made by the CSA in 2002 to introduce a registration requirement for mutual fund managers.[120] It is also in line with the approach currently adopted by the Registration Reform Project ("RRP"). The RRP is an initiative of the CSA and its objective is to create a flexible and harmonised registration regime that reduces the regulatory burden and increases administrative efficiencies. The RRP explained the rationale for registration:

> "The registration requirement is intended to ensure that those who trade in or advise on securities are competent and do not engage in inappropriate practices. It is also designed to address conflicts of interest, curb market manipulation, and minimize the risk that clients will suffer financial loss from a registered firm's financial failure. Registered individuals and firms must meet initial fit and proper requirements and they must continue to comply with rules for competency, ethical conduct, and financial responsibility in order to retain their registration status."[121]

[119] See section 7(i)(b) above.
[120] Canadian Securities Administrators, Concept Proposal 81-402 "Striking a New Balance: A Framework for Regulating Mutual Funds and Their Managers", March 1, 2002.
[121] CSA Registration Reform Project, Consultation Paper on the Registration Trigger and Regulated Activities, September 15, 2005.

The RRP noted the "incongruity" of the existing situation where dealers and advisers are required to register, but not fund managers. It also noted that a fund manager must have both the financial resources and the human resources to perform its functions or be able to supervise any functions that it contracts to a third party, and further observed that the fiduciary duty imposed under securities legislation could be hollow if a fund manager does not possess adequate resources, i.e., capital and insurance, to back it up.

Although the objectives are expressed in relation to mutual fund managers, we believe that they are equally applicable to hedge fund managers.

The principle of requiring the registration of fund managers seems to be gaining acceptance. In her inaugural speech, the current Chair of the Investment Funds Institute of Canada stated:

> "We should ask ourselves if a better and more effective answer to the issues that have surfaced in the last few months (Author's note: This is a reference to recent manager failures) lies in increased manager regulation, including higher capital requirements. I offer this view … as a former auditor with a fair understanding of what prevents bad things from happening. And I can tell you from that perspective, personal liability and capital-at-risk can serve as considerable deterrents." [122]

a) Private Equity and Venture Capital

Private equity is another form of absolute return investment. The point is sometimes made that hedge funds and private equity funds are converging. While it is the case that certain hedge funds are involved in strategies, such as distressed securities[123], that bear some resemblance with private equity investing, we believe that the extent of this convergence has been overstated. To explain why, we will compare and contrast the characteristics of hedge funds and private equity funds.

[122] Brenda Vince, "Leading Change", *Chair's Address at the Investment Funds Institute of Canada's 19th Annual Conference*, September 28, 2005.
[123] See Appendix 1 for a discussion of distressed securities.

Characteristics of Private Equity

Private equity funds usually take the form of limited partnerships. As general partner, the fund manager has sole authority to manage the partnership. The investors are limited partners. Private equity funds have a fixed life, usually eight to 10 years with a possibility of extension for another two years. There are typically no redemption opportunities.[124] Investors are locked in for the duration of the fund.[125] Investors in private equity funds are institutional and high net worth investors.

At the time of setting up the fund, the manager of a private equity fund will seek commitments from the investors to invest up to a certain amount. The amount is not invested immediately. Instead, the manager will make so-called capital calls over a period of time as and when investment opportunities materialize. The manager has a limited period of time in which to find investments. This period is called the investment period and is normally for the first three years of the fund. Once the investment period has ended, the manager is not allowed to make new investments, even if some of the committed capital is still uncalled. However, it can make follow-up investments in existing investments.

The fund will normally take sizeable stakes in the investee companies and the fund manager will take an active part in the management of the companies. The fund will normally have representation on the board of directors of the investee companies. A private equity manager adds value not only by picking promising investments but also by actively assisting the management of the investee companies.

When the manager believes that an investment has achieved its potential, the investment will be sold and the proceeds returned to the investors. A private equity fund typically does not hold cash balances since this will depress its internal rate of return. Usually, all the investments will have been sold and the proceeds returned to the investors by the end of the fund's fixed life.

Private equity managers are remunerated by means of a management fee, which is usually based on the committed capital during the investment period and on the invested capital thereafter, together with an incentive fee called the "carried interest," which is a percentage of the profits.

[124] A few private equity funds allow very limited redemption opportunities.
[125] There is a limited secondary market for private equity investments.

The carried interest is subject to the investors having received their capital back and earned a preferential return on their investment.

Unlike hedge funds that revalue their investments continuously, private equity funds normally carry their investments at cost until such time as the investment is realized or there is objective evidence that it has increased in value, such as when a third party makes a subsequent investment at a higher valuation. Any investments that fail are written off immediately. The pattern of returns of a private equity fund over time typically takes the form of a J-like curve. In the first few years, returns are negative because the investments are carried at cost and the fund incurs management fees. If the fund is properly managed, returns increase significantly over time as the investments are sold at a profit.

Because of the way that profits are recognized, private equity managers collect their incentive fees much later in the life of the fund in comparison with hedge fund managers that collect incentive fees on a periodic basis.

A venture capital fund is similar to a private equity fund. The main difference is that venture capital funds invest in earlier-stage companies whereas private equity funds invest in more mature companies.

We have summarised the main differences between private equity funds and hedge funds in Table 5.

Table5
Comparison between Private Equity Funds and Hedge Funds

		Private Equity Funds	Hedge Funds
1.	Life of fund	Fixed	Indefinite
2.	Open-end or closed-end	Closed-end	Open-end
3.	Redemption opportunities	No	Yes
4.	Immediate disbursement of investors' capital	No	Yes
5.	Limited investment period	Yes	No
6.	Active management of investee companies	Yes	No
7.	Representation on the board of investee companies	Yes	No
8.	Systematic return of proceeds to investors after the sale of an investment	Yes	No
9.	Holding of cash by the fund	No	Yes
10.	Continuous revaluation of investments	No	Yes
11.	Timing of incentive fees	Later	Earlier

Source: Author

It is obvious that the scope for hedge fund managers to make private equity investments is rather limited. There are two main reasons for this:

- The balance sheet of a hedge fund does not lend itself to significant private equity investments. The latter are very long-term investments. Although many hedge funds in the United States have recently lengthened their lock-up periods, especially in the context of the SEC's new look-through rule, the lock-up periods are still shorter than the time it typically takes to realize the value of a private equity investment. Borrowing short and lending long is the traditional recipe for financial disaster. Private equity funds do not face this risk because both sides of their balance sheet are long term.
- Private equity investing requires business management and operational skills that are not typically required in hedge fund investing.

Given that the scope for hedge funds to converge with private equity funds is limited, it makes sense for asset management firms to own hedge fund operations *alongside* private equity operations. Indeed, several investment banks have done precisely this as a way to offer a more complete range of alternative investments to their clients.

Private equity and venture capital funds do not give rise to the same concerns as hedge funds. In particular, the very long-term nature of the investment limits the extent of retailing. Consequently, we do not recommend that the registration requirements be extended to the managers of private equity and venture capital funds. A look at Table 5 suggests, there are many ways in which private equity and venture capital funds may be distinguished from hedge funds.

Recommendation #20: There is no need to extend the registration requirement to managers of private equity and venture capital funds.

b) Conditions of Registration

Our recommendations on the conditions of registration of hedge fund managers stem from the issues we have identified in this report. They are not intended to be comprehensive.

Fund management businesses are often started by advisers with a good track record in a previous position. However, running a fund management business requires more than investment prowess. In order to succeed, a business requires many other disciplines. We expect that registration will be dependent upon the manager being able to demonstrate a strong organizational structure, including the assignment of responsibility for the key areas of investment, risk management, finance, and compliance to specific individuals with appropriate experience and proficiency.

In line with our emphasis on internal control, we would also expect the manager to demonstrate that it has set up a proper internal control system. The internal control system should be documented.

The manager should be able to demonstrate the existence of a properly documented risk management policy and of properly documented due diligence procedures.

We note that the RRP proposes to impose a minimum capital requirement on fund managers. The rationale for such a requirement is well explained by IOSCO:

> "Although insolvency is not a common problem in fund management, it cannot be in the interests of investors (or regulators) to have this occur… It is important that the regulator is satisfied that the firm is sufficiently capitalized to cope with issues such as operational risk as well as having a sound business base to continue as a financially viable operation."[126]

The Erlichman report also recommended that minimum capital requirements and fidelity insurance requirements should be conditions of the registration of fund managers.[127]

The RRP did not specify how the minimum capital requirement would be calculated. We would like to offer our thoughts on this subject. We believe that capital and insurance requirements should be related to the business model of a fund manager, its needs for cash and the risks involved. We accordingly begin our analysis with a discussion of these topics.

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[126] Technical Committee of the International Organization of Securities Commissions, Investment Management: Areas of Regulatory Concern and Risk Assessment Methods, October 2002.

[127] Stephen I. Erlichman, Making it Mutual: Aligning the Interests of Investors and Managers – Recommendations for a Mutual Fund Governance Regime for Canada, June 2000.

d) Business Model of an Investment Fund Manager

The profit model of a fund manager is relatively simple. We shall first discuss the profit model of a mutual fund manager, then extend the discussion to include hedge fund managers.

The revenues of a mutual fund manager consist of management fees, which are calculated on average on the basis of 2 per cent of assets under management. In turn, assets under management depend on two main factors:

- Net sales of mutual funds, i.e., gross sales less redemptions; and
- The investment performance of the funds, commonly referred to as the “market effect”.

The market effect constitutes a veritable boon for fund managers because it exposes them to the secular upward trend in the market. A rise in the market leads to an automatic increase in assets under management, hence revenues and profit. No additional investment or effort is required to benefit from this automatic increase.

Operating costs consist of trailer fees to intermediaries, which are a function of assets under management, and other operating costs such as salaries, marketing, and sub-advisory fees. Except for sub-advisory fees, which depend on assets subject to sub-advisory agreements, most other operating costs are fixed. This means that economies of scale are very important in this industry. As assets under management increase, operating costs rise less than proportionately. Once past a critical level of assets under management, the operations of a fund manager are impressive cash generators.

We have summarised in Table 6 below the profit model of a fund manager with critical mass, based on our own research. Management fee revenue amounts to approximately 200 basis points of assets under management.[128] Operating costs amount to approximately 100 basis points of assets, of which approximately 50 basis points of trailer fees to intermediaries and 50 basis points of other operating costs.

[128] One basis point is one hundredth of 1 per cent.

Thus, operating profit or EBITDA (Earnings before interest, taxes, depreciation, and amortization) amounts to approximately 100 basis points of assets under management.

Table 6
Profit Model of a Mutual Fund Manager with Critical Mass
(in basis points of assets under management)

Management fee revenues		200
Operating costs		
Trailer fees to intermediaries	50	
Other operating costs	50	100
Earnings before interest, taxes, depreciation and amortization (EBITDA)		100

Source: Author

EBITDA is the most commonly used measure in financial analysis. It approximates sustainable cash flow from operations. Please note that EBITDA excludes a number of items.

- Sales commissions to intermediaries on the sale of mutual fund units with a DSC are not treated as expenses. Instead, they are capitalized and subsequently amortized over a period of time, corresponding to the period over which DSCs or redemption fees are chargeable to the investor.[129] Amortization expenses are excluded from EBITDA because they are non-cash charges.
- Redemption fees are charged by the manager to investors who redeem within six or seven years any units purchased with a DSC. Redemption fees are a source of revenue to the manager but are excluded from EBITDA because they do not constitute a sustainable source of cash flow. After all, a mutual fund unit may only be redeemed once.
- Interest revenue and expense are excluded because they are financial and not operating items.
- Income taxes are excluded, more for reasons of convenience than anything else.

[129] See section 5(vii)(b) for a discussion of deferred sales charges.

The profit model of a hedge fund manager is similar to that of a mutual fund manager, with two main differences. First, in addition to asset-based management fees, the hedge fund manager will earn performance fees. Second, because a hedge fund manager often has a smaller asset base over which to spread its costs, other operating costs may be more than 50 basis points of assets. In fact, in the case of small managers, it would not be unusual for operating costs to be higher than management fee revenue. This is true of all types of fund manager.

Strengths of the Business Model

Few business models are as strong and impervious to business cycles as that of a fund manager.

Revenues, being based on assets under management, are relatively stable. Contrast this with the commission-based revenues of certain dealers. Commissions depend on the volume of transactions, which is likely to dry up when the markets are down.

Since management fees are paid out of the fund's assets, a fund manager never experiences any credit risk.

A large portion of expenses, such as marketing, is discretionary in nature. When times are tough, such as during bear markets, discretionary expenses may be cut altogether. To the extent that other fund managers are doing the same, there should be no adverse effect on the manager's competitive position.

To the extent that investors have purchased units of mutual funds with a DSC, they have almost condemned themselves to paying fees to the manager one way or another. If they remain invested, they will pay management fees. If they redeem their units within six or seven years, they will pay redemption fees.

Few businesses exhibit defensive characteristics as strong as those of the fund manager.

Risks of the Business Model

The business model of a fund manager faces a number of risks. These may be analyzed into business risks, operational risks, and financial risks.

We believe that financial risks are the most serious, particularly in the case of smaller managers.

Business Risks

A market correction will result in a drop in management fee revenues. However, as explained above, it is possible to offset this by cutting on discretionary expenses such as marketing.

Other business risks include competition from other investment fund managers and other investment vehicles. Competition may affect the net sales or operating margins of a manager. Some industry observers have predicted for some time that price competition will heat up and result in a compression in operating margins.

The business is crucially dependent on the investor's confidence in the integrity of the system. When investors lose confidence, sales may dry up. The recent cases of market timing have made no lasting impact on investor confidence. The high-profile failures of certain fund managers seem to have had more of an impact, but only in specific segments of the industry.

Operational Risks

Among operational risks, potentially the most serious is that of fund pricing errors. These errors can be extremely expensive to the manager, especially if they remain undetected over a long period of time or if the fund experiences a substantial turnover of unit holders through purchases and redemptions of units. IFIC's correction standards for fund pricing errors require the manager to reimburse the fund for any loss in excess of 0.5 per cent of the fund's net asset value and adjust all investor accounts where the impact is $50 or more.[130] The amount of reimbursement may be equivalent to several years' of management fees.

A manager may insure itself against fund pricing errors through an Errors and Omissions policy, subject to the deductible amount.

[130] Investment Funds Institute of Canada, Bulletin No. 22: Correcting Portfolio NAV Errors, August 2000.

<u>Recommendation #21</u>: Errors and Omissions coverage should be mandatory for fund managers.[131] The minimum regulatory capital should include the amount of any deductible.

Financial Risks

By financial risk, we mean the risk of the manager failing through inadequate capitalisation of the business. A business is properly capitalised when it has enough cash resources to take advantage of all business opportunities. Table 7 below examines the sources and uses of cash of a fund manager.

Operations may either generate or use up cash, depending on whether EBITDA is positive or negative. Given the fixed nature of certain costs, smaller managers are particularly at risk of experiencing negative EBITDA.

Table 7
Sources and Uses of Cash of a Fund Manager

Sources of cash
- Cash from operations (EBITDA)
- Redemption fees
- New financing

Uses of cash
- Cash used in operations (negative EBITDA)
- Sales commissions
- Interest expenses
- Repayment of debt
- Income taxes

The payment of commissions to intermediaries on the sale of units with a DSC may be necessary to allow a manager to expand. We pointed out in section 5(vii)(b) that access to additional capital to finance the payment of sales commissions may be a competitive advantage. Access to outside

[131] We are aware that E&O coverage for managers is expensive. This, in itself, is indicative of the degree of risk involved. We realize that mandatory E&O coverage will increase managers' costs and that these will be ultimately borne by the investors. These incremental costs have to be balanced against the costs of manager failure which may include financial loss to investors as well as a loss of confidence causing investors to turn away from investment funds.

capital is particularly important for smaller managers that do not generate sufficient cash internally.

When investors redeem units purchased with a DSC, the manager will receive redemption fees.

If the manager has borrowed money, it will face contractual payments in the form of interest payments and repayment of capital.

In many industries, investment in fixed assets and incremental working capital are necessary to support the growth of the business. However, in the case of fund managers, the requirements for cash and working capital are typically not large.

Inability to fund the payment of sales commissions will jeopardise the growth of the manager. However, inability to finance operating losses (negative EBITDA) may lead to the short-term failure of the manager.

Inability to honour contractual interest payments or capital repayments may also lead to the same result. However, it would be possible to make debt servicing payments contingent on the prior permission of the regulatory authority.

d) Minimum Capital Requirements

The objective of minimum capital requirements is not only to reduce the risk of manager failure. It is also to ensure that the owners of the business have some capital at risk. This in itself should ensure a certain degree of discipline in the way that the business is run.

The point is sometimes made that minimum capital requirements constitute a barrier to entry. Our experience is that the venture capital industry in Canada is dynamic enough that new entrants with a proper track record and a solid business plan should find it possible to raise the requisite capital.

Capital requirements are only one tool for managing the risk associated with a fund manager's business. Other essential components of a risk management system are honest, competent management, and strong internal controls. Indeed, in the absence of internal controls, the regulator can have no assurance that the reported capital fairly reflects the true position of the business.[132]

An important feature of the business model of a fund manager is that fund investors' assets are never commingled with the manager's assets. This reduces the risk to the fund investors.

From an economic perspective, a business is properly capitalized when it has enough cash resources to take advantage of all available business opportunities. From a regulatory perspective, it is probably not necessary to use such an exacting yardstick. Instead, we suggest that the minimum regulatory capital should be set at a level sufficient to ensure that the manager will continue as a going concern in the foreseeable future.

In the light of this objective and given the business model of fund managers, we recommend that the minimum capital should be set at an amount equal to expenses of a certain number of months, say three or six months, together with a fixed amount to serve as a cushion. The exact number of months' expenses to be required will depend on the frequency with which the regulatory authorities intend to review the financial statements of the registrant.

<u>Recommendation #22</u>: Fund managers should be required to have minimum capital amounting to expenses of a certain number of months together with a fixed amount to serve as a cushion.

Obviously, financial statements in prescribed form should be submitted promptly and regularly. To provide some context for the interpretation of the financial statements, the filings should also include operational data such as gross sales, redemptions, net sales, and average and closing assets under management. Unusually trends such as a very fast rate of growth of assets under management[133] or very heavy redemptions would alert the regulatory authorities to potential problems.

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[132] Jeremy Richardson and Michael Stephenson, Some Aspects of Regulatory Capital, Occasional Paper No. 7, Financial Services Authority, March 2000.
[133] The case of Portus comes to mind.

Recommendation #23: To provide some context for the interpretation of the financial statements, the filings should also include operational data such as gross sales, redemptions, net sales, and average and closing assets under management.

We recommend that new entrants to the industry should be required to submit a business plan showing, among others, the cash needs of the business for the foreseeable future together with the available sources of cash.

Recommendation #24: New fund managers should be required to submit a business plan as a condition of registration.

e) Minimum Assets under Management

As an additional protection for investors, consideration should be given to requiring the manager to have a minimum level of hedge fund assets under management prior to launching retail hedge funds.[134] This would serve two purposes. First, it would ensure that the manager has prior expertise of managing hedge funds for high net worth and institutional clients. Secondly, it would ensure that the manager has a steady stream of revenues, thereby lessening the risk of running out of cash.

Recommendation #25: Consideration should be given to requiring managers of retail funds of hedge funds to have a minimum level of hedge fund assets under management prior to launching retail hedge funds.

(vi) Qualifications of the Adviser

It would be prudent to follow the example of other jurisdictions in requiring the adviser to have employees with a certain number of years' experience in applying hedge fund strategies. This should include specific experience of funds of hedge funds.

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[134] In Hong Kong, minimum assets under management of US$100 million are required. See section 4(iii)(a).

Recommendation #26: The employees of the adviser of a retail fund of hedge funds should have a certain number of years' experience in applying hedge fund strategies, including specific experience of funds of hedge funds.

vii) The Intermediary and the Selling Process

The role of investment dealers in the distribution of hedge funds has already been extensively reviewed in the IDA report.[135] The report made the following recommendations for IDA action in respect of its member firms:

- Re-issue the advisory to all members reminding them of the prohibition of "off-book" transactions.
- Develop industry guidance as to acceptable practices for referral arrangements.
- Issue an advisory to all members as to their responsibility to conduct due diligence on products recommended to clients.
- Review guidelines or standards regarding disclosure, conflicts of interest, and internal controls for members acting as manufacturer, adviser, manager, and distributor of hedge funds or pooled funds and determine whether such standards need amendment.
- Restrict members from conducting securities-related activities in an affiliate with a limited market dealer registration when such activities could be conducted by the member.

We would like to focus our own comments on the suitability requirement, which we see as fundamental to the advice-giving function. Intermediaries are responsible for ensuring the suitability of all investments that they sell to a client. This is as it should be. It is in the implementation of the suitability requirement by intermediaries and its enforcement by regulators that improvements are required.

In order to implement properly the suitability requirement, intermediaries must have knowledge both of the client and the product.

[135] Investment Dealers Association of Canada, *op. cit.*

<u>Recommendation #27</u>: The implementation of the suitability requirement should be improved through greater emphasis on knowledge of the product on the part of intermediaries and more stringent enforcement by regulators.

KYC and KYP

Knowledge of the client is enshrined in the "Know-Your-Client" or "KYC" rule, which is well understood throughout the industry. Knowledge of the client is gained, among other means, through the completion of a questionnaire that enables the intermediary to establish the client's investor profile comprising such matters as the client's knowledge of investment matters, investing goals, investing horizon and degree of tolerance to risk.

Knowledge of the product is a requirement that is less understood. In this context, the MFDA is to be commended for the recent issue of a regulation notice entitled "Know-Your-Product".[136] The notice seeks to clarify the obligations of mutual fund dealers with respect to the approval and sale of investment products. Hopefully, KYP will one day become as familiar an acronym as KYC.

The MFDA insists that mutual fund dealers must have a complete understanding of the products they sell. This understanding must be arrived at independently and objectively and not on the basis of mere reliance on the representations of the manager.

All products should be subject to a reasonable level of due diligence prior to being included on an approved product list. Novel or more complex products should be subject to more extensive review than conventional mutual funds. The MFDA provides a list of tasks to be performed during a due diligence review.

viii) <u>Enforcement</u>

We have two recommendations relating to enforcement.

A Centre of Hedge Fund Expertise

Proper enforcement of the retail hedge fund regulations would require an understanding of the industry.

The FSA has recently set up a Hedge Fund Managers Supervision team within its organization to serve as a centre of hedge fund expertise.[137] The team is responsible for managing relationships with high-impact firms and to carry out thematic supervision of hedge fund managers. Through AIMA, the British hedge fund industry has expressed willingness to assist the centre in its learning process.

We believe that it would be beneficial for the securities commissions to set up a similar centre. To avoid duplication, the centre could be a unit of the CSA. In addition to the management of relationships with participants in the hedge fund industry and the thematic supervision of managers, we envisage that the centre will assist in the development of regulatory policy for the industry and provide advice to the various departments of the securities commissions on all hedge fund matters.

<u>Recommendation #28</u>: A centre of hedge fund expertise should be set up. To avoid duplication, the centre could be a unit of the CSA.

Use of Fraud Predictors within Risk Assessment Models

In 2002, IOSCO surveyed the risk assessment models used by regulators to assess the relative riskiness of fund managers.[138] These models can be useful in deciding which firms to inspect and what matters to inspect in detail. However, it is clear from the survey that these models are not easy to construct.

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[136] Mutual Fund Dealers Association of Canada, Member Regulation Notice: Know-Your-Product, October 31, 2005.

[137] See section 4(ii)(a).

[138] Technical Committee of the International Organization of Securities Commissions, Investment Management: Areas of Regulatory Concern and Risk Assessment Methods, October 2002.

Research has identified a number of fraud predictors.[139] These can be applied with relative ease and we believe that their use within regulators' risk assessment models can enhance the identification of potential problems ahead of time. Predictors of fraud include:

- Opportunity factors, such as significant related-party transactions and ineffective monitoring of management;
- Motivational factors, such as pressure to report favourable financial results and to achieve rapid growth; and
- Management attitudes, such as disputes with the predecessor auditor and prior-year irregularities.

Some of these fraud predictors were present in the cases of manager failure that have recently occurred in Canada.

<u>Recommendation #29</u>: Fraud predictors should be incorporated within regulators' risk assessment models to help identify potential problems ahead of time and decide which firms to inspect and what matters to inspect in detail.

ix) Our Recommendations and the Task Force's Terms of Reference

The axioms underlying the terms of reference of the Task Force are:

- "that a dynamic and efficient capital market in Canada contributes to economic growth through the effective mobilization of savings and cost-effective access to capital for new and existing businesses and for governments;
- that high standards of investor protection and market integrity are critical to preserving investor confidence; and
- that modern, balanced and responsive securities regulation is essential to ensuring a dynamic, fair, efficient and competitive capital market."

We submit that our recommendations are pertinent to the mandate of the Task Force and proportionate to the issues at hand. We believe that they will contribute to:

[139] Denis Cormier and Pascal Lapointe, "To Assess and Detect", *CA Magazine*, November 2005.

- the improvement of the standards of investor protection, thereby enhancing investor confidence;
- the effective mobilisation of savings by providing retail investors with wider investment choices and enabling them to improve the efficiency of their portfolio through direct, efficient access to alternative investment strategies; and
- the dynamism of the capital market in Canada by opening the market to an entirely new class of investment products, namely the retail hedge fund.

Abbreviations

AIMA	Alternative Investment Management Association
AIMA Canada	Canadian Chapter of AIMA
BaFin	German Federal Financial Supervisory Authority
CIS	Collective Investment Scheme
CSA	Canadian Securities Administrators
DSC	Deferred Sales Charge
EBITDA	Earnings before Interest, Taxes, Depreciation and Amortisation
EEA	European Economic Area
EU	European Union
FSA	Financial Services Authority (UK)
FSF	Financial Stability Forum
GAAP	Generally Accepted Accounting Principles
GST	Goods and Services Tax
IDA	Investment Dealers Association of Canada
IFIC	Investment Funds Institute of Canada
IOSCO	International Organization of Securities Commissions
IRC	Independent Review Committee
MAS	Monetary Authority of Singapore
MER	Management Expense Ratio
MFDA	Mutual Fund Dealers Association of Canada
NAV	Net Asset Value
NI 45-106	National Instrument 45-106 *Prospectus and Registration Exemptions*
NI 81-101	National Instrument 81-101 *Mutual Fund Prospectus Disclosure*
NI 81-102	National Instrument 81-102 *Mutual Funds*
NI 81-104	National Instrument 81-104 *Commodity Pools*
NI 81-105	National Instrument 81-105 *Mutual Fund Sales Practices*
NI 81-106	National Instrument 81-106 *Investment Fund Continuous Disclosure*
OSC	Ontario Securities Commission
OSFI	Office of the Superintendent of Financial Institutions
RRP	Registration Reform Project of the CSA
SEC	Securities and Exchange Commission (U.S.)
SFC	Securities and Futures Commission (Hong Kong)
UCITS	Undertakings for Collective Investment in Transferable Securities

Appendix 1 How Hedge Funds Make or Lose Money

In this appendix, we have attempted to demystify hedge funds by providing some insights into a number of investment strategies covering all three categories. Observe in each case how the hedge fund's performance depends on the adviser's skills, e.g., at picking the right stocks. Observe also how the hedge fund is able to generate a positive return even if the overall market is down.

We have also tried to explain the risks involved in each strategy and how they may cause the fund to incur losses.

Convertible Arbitrage

Convertible arbitrage is an example of a relative-value strategy. It involves investing in the securities of an issuer that has issued convertible bonds as well as common stock. Convertible bonds pay current income just like ordinary bonds. In addition, they are convertible into common stock at a given or determinable price. These bonds are usually issued with a conversion price much higher than the current stock price. As the stock price increases over time, it may exceed the conversion price, in which case the bondholders can profit from converting their bonds into stock.

In a convertible arbitrage strategy, the hedge fund will buy the convertible bond and short sell a number of common shares. Because of the conversion feature, the price of the convertible bond will fluctuate in line with the price of the underlying shares. If the stock price goes up, the loss on the short position in common shares will be offset by the gain on the convertible bond. On the other hand, if the stock price declines, the gain on the short position in common shares will be offset by the loss on the convertible bond. The hedge fund has thus protected itself against changes in market conditions.

The hedge fund's return will be in the form of the interest income from the convertible bond. This will be enhanced by interest income on the proceeds of the short sale of the common shares. Leverage is often used to magnify the return.

Convertible arbitrage is a hedge fund strategy with relatively low risk. Among the risks of investing in convertible bonds, we may mention interest rate risk. The price of the bond will be adversely affected by an increase in interest rates. The ultimate risk is that of default, where the issuer is unable to make the interest payments or repay the principal at maturity. However, there are ways to manage these risks.

Merger Arbitrage

Merger arbitrage belongs to the category of event-driven strategies. The latter derive their name from the fact that they seek to profit from a corporate event, for instance, a merger. Consider the case of a company ("Acquirer") making an offer to buy another company ("Target"). Acquirer offers two of its own shares in exchange for every share of Target. At a given time, the shares of Acquirer are trading at, say, $25 each, implying a value of $50 for each share of Target. At the same time, the shares of Target are trading at, say, $43. The spread of $7 exists because there is a risk that the deal may not be concluded, perhaps because it is blocked by a regulatory authority or because Acquirer's offer is rejected by the shareholders of Target.

Strategies that take advantage of such spreads are known as merger arbitrage. In our example, this involves buying one share of Target for $43 and short selling two shares of Acquirer for proceeds of $50. If the merger is indeed completed, the arbitrageur will end up with a long position of 2 shares of Acquirer (on tendering the one share of Target), a short position of 2 shares of Acquirer and a profit of $7. This profit will have been achieved with no net exposure to Acquirer or indeed to the stock market in general.[140]

The risk is that of non-completion of the merger. In this event, the stock price of Target will probably fall and the arbitrageur will incur a loss on its long position in Target. The stock price of Acquirer may rise or fall, depending upon how investors viewed the merger. If investors thought that the proposed price for Target was too rich, they will be relieved that the merger will not be concluded and the stock price of Acquirer may rise as a result. In this event, the arbitrageur will also incur a loss on his short position in Acquirer. Success in event-driven investing depends on being able to analyze the situation and predict its eventual outcome.

[140] To simplify the example, we have ignored transaction costs, dividends and interest.

Event-driven strategies have capacity constraints. In other words, there is a limit to the assets that may be invested in such strategies. This limit is determined by the number of mergers and other corporate events taking place at a given point in time.

Distressed Securities

Funds that invest in distressed securities are commonly known as vulture funds. These funds invest in the bonds and sometimes the shares of issuers in financial distress. Such issuers may have defaulted on their obligations or may be in bankruptcy or bankruptcy protection.

As an investment strategy, distressed securities are a form of event-driven investing. The event here is the financial distress of the issuer. The opportunity to profit from this situation arises from the fact that the market for distressed securities is very inefficient. Many investors shun defaulted bonds for fiduciary or other reasons and prefer to stick to the comfort of investment grade bonds. When there is a shortage of interested investors, it is often possible to buy securities at favourable prices. If and when the business and finances of the issuer are successfully restructured, it may be possible to resell the securities at a profit. Even if the issuer is wound up because of the failure of the restructuring, it may still be possible to make a profit, depending on the size of any liquidation distributions.

Investing in distressed securities carries significant risk. Here again, success depends on being able to analyze the situation and predict its eventual outcome. The latter will depend on factors such as the viability of the underlying business, its break-up value, and the availability of fresh capital. Some vulture funds actively attempt to influence the outcome of the restructuring. This may have contributed to the reputation of hedge funds as somewhat frightening. Other funds adopt a more passive approach.

It should be noted that the factors affecting the outcome of a distressed situation are very specific to the issuer. These factors play a greater role in the return of the hedge fund than general market conditions.

Long Short Equity

Long/short equity is an example of an opportunistic strategy. It is the most widely used hedge fund strategy, probably because, unlike some other strategies, it is not subject to capacity constraints.

This strategy involves buying a basket of stocks that are judged to be undervalued and at the same time short selling another basket of stocks that are believed to be overvalued. Some funds choose not to cancel out the long and short positions. If the adviser believes that the market as a whole will go up, it may choose to have a net long exposure. Likewise, if the adviser believes that the market will fall, it may choose to take a net short position.

The expectation when buying a basket of undervalued stocks is that its price will rise as and when the market recognizes the undervaluation and the basket price gravitates to its fair value. Similarly, one expects that the price of a basket of overvalued stocks will drop. In long/short equity investing, a profit is made if the long basket performs better than the short basket.

Suppose the price of the long basket rises and that of the short basket drops. In this case, the hedge fund will benefit from both its long and short positions.

Now, let us say that there is a rise in the prices of both baskets. If the price of the long basket rises by more than that of the short basket, the gain from the long basket will more than offset the loss from the short basket, leaving a net gain.

Now suppose that there is a decline in the prices of both baskets. If the price drop of the long basket is less than that of the short basket, the loss from the long basket will be more than offset by the gain from the short basket, again leaving an overall net gain.

It is thus possible to profit from long/short equity investing in both rising and falling markets. What matters is the adviser’s stock-picking ability In other words, its ability to recognize which stocks are overvalued and which are undervalued.

It is possible to increase the return from long/short equity strategies by leveraging the long and short positions.

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