Canadian Securities Administrators' Staff Notice 81-316

Hedge Funds

Background

CSA staff conducted a sample-based review of hedge funds in Canada, beginning in early 2005 and continuing into 2006, which involved a combination of compliance reviews of hedge fund managers and advisers, disclosure reviews and industry consultations. We did this review because we recognized the trend of increasing retailization of hedge funds. It was also important to us to examine the issues raised about hedge funds regulation as a result of the failure of certain hedge funds in Canada and globally.

"Hedge funds" can be difficult to define. For the purposes of our review, we used a broad definition of hedge funds: investment pools that use alternative investment strategies not generally available to traditional mutual funds such as taking both long and short positions and using arbitrage, leverage, options, futures, bonds and other financial instruments to capitalize on market conditions.

We also considered the report by the Task Force to Modernize Securities Legislation in Canada issued in October 2006 (the Allen Report) which covered a wide range of topics including hedge funds and principal protected notes (PPNs).[1]

General conclusion

We concluded that our regime contains an appropriate securities regulatory framework for hedge funds, but that certain areas within it could be improved. Those areas are discussed later in this notice under "Areas of Concern".

Two topics identified in our review -PPNs and referral arrangements- we thought needed further in-depth study. On July 7, 2006 the CSA issued Canadian Securities Administrators' Notice 46-303 Principal Protected Notes (the PPN Notice) that outlined the CSA's concerns with the distribution and sale of PPNs and signaled the CSA's intention to do further consultations on PPNs. Referral arrangements are being studied through a separate CSA project the results of which will form part of the CSA Registration Reform Project.

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[1] The Allen Report canvassed several issues relating to hedge funds and made recommendations to address them, including that:

- A regulatory framework for the public offering of hedge funds be established, similar to the framework for mutual funds;
- PPNs linked to hedge funds be regulated according to the nature of the underlying investment rather than the character of the note;
- Financial intermediaries selling hedge funds and other structured products linked to hedge funds meet certain proficiency requirements; and
- Hedge fund managers be registered.

Finally, as discussed in more detail later in this notice, the CSA, through the Registration Reform Project, is proposing to require the registration of fund managers.

What we covered in our review

1. Current regulation of hedge funds

Hedge funds are distributed in different ways – under a prospectus, under exemptions in securities legislation that allow them to be sold without a prospectus and, in some cases, through linked products, such as PPNs, that are sold on the basis that they fall outside the scope of provincial securities legislation[2].

Hedge funds sold under a prospectus or through exemptions in securities legislation are regulated through a range of general securities legislation requirements:

- *Portfolio managers* who manage the fund portfolios must be registered. In this Notice, portfolio managers are referred to as "*advisers*", as they provide advice to the funds on the portfolio of securities held by the fund. This is in contrast to the situation in the United States, where most hedge fund advisers are exempt from regulation.[3]
- *Dealers* who sell securities must be registered.
- *Know your client (KYC) and suitability requirements (which include knowing your product)* must be met by registered advisers and dealers advising on or selling hedge funds.
- *Hedge funds sold without a prospectus* can be sold only to:
    - accredited investors who meet certain net income or financial asset tests;
    - investors who can make a minimum purchase in the fund of $150,000;
    - investors in certain jurisdictions[4] who receive a mandated form of disclosure and acknowledge the risk of the investment they are making. Investors have 2 days to change their minds about the investment and have certain rights of action if the disclosure contains a misrepresentation.
- *Disclosure requirements apply, depending on how the hedge fund is sold:*
    - funds of hedge funds sold under a prospectus are required to give full, true and plain disclosure about the fund;
    - hedge funds sold to accredited investors or investors purchasing at least $150,000 are not technically required to provide disclosure, although in our review we found that some form of offering document was usually provided;

[2] Or, in Québec, under an applicable exemption (see section 3(9) or 3(14) of the *Securities Act* (Québec)).
[3] The U.S. *Investment Company Act of 1940* exempts from its requirements funds that limit their distribution to private placements with high net-worth individuals or institutions, or that have 100 or fewer beneficial owners. The U.S. *Investment Advisers Act* is interpreted as exempting portfolio managers who act on behalf of 14 or fewer funds.
[4] British Columbia, New Brunswick, Nova Scotia and Newfoundland and Labrador.

- hedge funds sold under the offering memorandum exemption[5] must provide a specific form of offering memorandum to investors.

- *Continuous disclosure* (such as financial statements) must be provided by prospectus-qualified funds of hedge funds and, in some jurisdictions[6], by hedge funds sold under certain exemptions.
- *Compliance reviews of* advisers, fund managers and dealers are performed by compliance staff of the securities regulatory authorities and the SROs using risk-based approaches.

Investors can also get access to hedge funds through linked products such as PPNs that are sold on the basis that they fall outside the scope of provincial securities legislation. As noted above, the CSA has raised certain concerns with PPNs and is looking into them through the consultation process discussed in the PPN Notice.

2. Compliance reviews of hedge fund managers and advisers

Certain CSA jurisdictions (Ontario, British Columbia and Quebec) conducted coordinated field examinations of 13 market participants, which included hedge fund advisers and managers. The population covered by the reviews included 37 hedge funds with a total value of $1.25 billion and 9 PPNs with a value of $1.4 billion. Market participants were chosen for a field examination based on their size, the number and types of products offered (hedge funds, funds of hedge funds and PPNs) and also included a random sampling.

The reviews focused on a number of areas, including the safeguarding of client assets, valuation processes, marketing materials and offering documents, the extent and type of fees being charged, product liquidity, the existence of referral arrangements and product distribution.

Generally, our findings across the participating jurisdictions were consistent. Our reviews revealed the following:

- *Custody* - Client assets were held in safekeeping predominantly by large, reputable third parties such as banks, dealers and trust companies.

- *Valuations* – Valuations for hedge funds were performed on a reasonably frequent basis (weekly, bi-weekly, monthly) either in-house or by third party service providers. When valuations were performed in-house, automatic price feeds from various external sources were used to minimize the risk of pricing errors. When valuations were outsourced, the only issue noted was that many of the market

[5] See footnote 4, in British Columbia, New Brunswick, Nova Scotia and Newfoundland and Labrador.
[6] Under NI 81-106 *Investment Funds Continuous Disclosure* in Ontario, Quebec, Saskatchewan, Nova Scotia and New Brunswick, hedge funds that are not reporting issuers are still required to provide certain continuous disclosure to investors.

participants did not maintain evidence of their oversight review of the funds' calculation of net asset value (NAV).

- *Marketing* – We had concerns about the presentation of performance returns and inadequate or inaccurate disclosure in some of the marketing materials we reviewed. In some cases, actual performance returns were presented together with simulated back tested data and disclaimers accompanying these types of performance presentations were weak.

- *Fees* – The reviews revealed that there are multiple layers of fees in hedge funds, including management fees, performance fees, up-front sales fees, trailer fees, and early redemption fees. In the case of funds of hedge funds, there is an additional layer of management and performance fees. While the fees associated with these products were disclosed in the offering documents, we had concerns with the clarity of the disclosure, the fact that the disclosure of various fees often appeared in many unrelated places in the documents and not on a consolidated/summary basis, and with the transparency of the overall levels of fees.

- *Exempt offering disclosure* –While we found that the product disclosure covered information similar to prospectus-level disclosure, there was a lack of consistency in the presentation of information. Given that these are complex products with layered structures and multiple fees, this made the disclosure difficult to understand and compare across products.

- *Liquidity* – The majority of the hedge funds reviewed in our sample that were sold in the exempt market allowed for weekly or monthly redemptions at NAV. Prospectus qualified funds were traded daily on the exchange.

- *Referral Arrangements* – We noted certain issues relating to referral arrangements in Ontario and British Columbia. In Ontario, there was an instance where a registrant inappropriately delegated its responsibility to supervise trades and assess the suitability of trades for its client to a non-registrant. The written agreement between the registrant and non-registrant did not clearly set out the roles and responsibilities of each party, including who was responsible for disclosure of the referral arrangements to clients. In British Columbia, there was an instance relating to inadequate disclosure of conflicts of interest. These instances were not representative of the population.

- *Distribution* – During the compliance reviews, we found that hedge funds and PPNs were frequently distributed through investment dealers and mutual fund dealers. In British Columbia and Quebec, the majority of hedge funds were distributed by the funds' portfolio managers.

3. Disclosure reviews

We completed disclosure reviews on a number of hedge funds, funds of hedge funds and PPNs through regular prospectus reviews, focused disclosure reviews and through reviews of hedge fund managers. We looked at hedge fund prospectuses, offering memoranda and sales communications and marketing materials.

4. Industry consultation

We consulted with a variety of industry professionals on issues relating to hedge fund distribution, disclosure, retailization and regulatory requirements. We discussed the importance of registrants completing adequate due diligence and know-your-product assessments on hedge fund investments before recommending them to clients, along with the equally important obligation of a registrant to meet its KYC and suitability obligations.

Industry representatives told us that investors want more access to hedge funds and that other markets and regulators around the world have moved to support increased retail access to hedge funds. The importance of the PPN market was also discussed, particularly as PPNs are used as a way to give retail investors access to hedge funds.

Areas of concern

While we concluded that the current securities regulatory framework for hedge funds is appropriate, in the course of our review we noted some areas that we should continue to monitor or that could be improved. These areas are described below, along with our views on how we intend to monitor or make improvements to them.

A. Principal protected notes

In the PPN Notice the CSA outlined a number of concerns with PPNs:

- they give retail investors access to alternative asset classes that are not usually available to retail investors without a prospectus, and that carry different risks;
- investors may not be getting sufficient disclosure about the PPN (for example, on the structure, fees and risks) to make an informed investment decision;
- some PPNs are linked to more complex investments and may pose more investment risk than was contemplated when securities legislation was enacted to exclude financial institution deposits from securities regulation and to exempt guaranteed debt instruments;
- registrants selling PPNs may not be meeting their KYC and suitability obligations.

The CSA is continuing its further consultation on PPNs.

B. Referral arrangements

Securities legislation in some jurisdictions and some self-regulatory organizations have specific requirements for how registrants handle referrals to and from registrants. Even where specific requirements do not exist, registrants are still bound by their obligations under securities legislation and their general obligation to act in the best interests of their clients.

We see certain risks with referral arrangements. One of the risks is that the roles and responsibilities of the different registrants involved in the referral, including who must disclose the arrangement to the client, may not always be clearly established. Another risk is that registrants will refer clients to someone selling hedge funds or products linked to hedge funds simply because of the fees the registrants will receive, without considering whether the referral is in the best interests of their clients.

There is a separate CSA project on referral arrangements that is examining ways to address concerns relating to referral arrangements and the results of this work will form part of the CSA Registration Reform Project.

C. Distribution

Dealers should ensure that they and their salespersons have sufficient proficiency and product knowledge of these very complex products to adequately assess suitability of the products for their clients. The dealer SROs should monitor that dealers and their salespersons are performing reasonable KYC and suitability assessments in the distribution of hedge funds.

D. Registration and oversight of fund managers

Currently, fund managers need not be registered unless they are also managing portfolio assets, in which case they must be registered as advisers. However, recognizing the role fund managers play in establishing, promoting and running investment funds and providing or overseeing a broad range of services (including fund valuation and registrar and transfer agency activities), the CSA is proposing to require the registration of fund managers, including hedge funds, through the Registration Reform Project.

The registration requirements for fund managers would focus on ensuring that they:

- have the resources to carry out their functions, or to properly supervise the functions if they are contracted to a third party, and to provide proper services to investors;
- manage their conflicts of interest;
- have adequate capital and insurance to provide protection for investors and minimize the risk of loss and disruption to them;
- have sufficient proficiency and integrity to carry out their functions.

Also, subject to resource requirements and overall compliance priorities, we will consider continuing our compliance/examination field reviews of the hedge fund industry participants including advisers and fund managers (in the jurisdictions with the statutory ability to do these reviews).

E. Disclosure

In the course of our review, we found that the non-prospectus offering disclosure (typically an offering memorandum) provided by some of the hedge funds could have been clearer. We will continue to review non-prospectus offering documents in the course of any compliance reviews of hedge fund managers and advisers and note any disclosure concerns to them in the course of those reviews.

Prospectus-qualified funds of hedge funds are reviewed through our established prospectus review program. These products tend to be complex and in our reviews we will continue to concentrate on clear disclosure about the funds including their structures, risks and the fees associated with them.

We will respond to problematic marketing materials that may come to our attention by requiring them to be modified or withdrawn. Some CSA jurisdictions may also review these materials as part of a continuous disclosure review program. In any reviews we may conduct, the following guiding principles[7] will be considered:

- past performance can only be shown if certain standard periods are included and if it is calculated in a standard way;
- past performance of an underlying fund or other funds managed by the same adviser may be shown, but only if it is clear that the disclosure relates to another fund under common management or if the fund being sold is linked to the fund being advertised;
- sales communications must include clear warning language about how data is calculated and that past performance does not indicate future performance;
- performance data must be sufficiently current so as not to be misleading;
- there must be clear and understandable disclosure of other key elements of the product, including fees and costs.

F. Financial disclosure and valuation

Through our regular prospectus reviews and through discussions of numerous transition questions around National Instrument 81-106 Investment Funds Continuous Disclosure, we identified several challenges for hedge funds that may be required to meet the valuation and financial disclosure requirements of NI 81-106, such as:

- for funds linked to offshore hedge funds, completing financial disclosure for the Canadian top fund within 90 days of the fund's year end;

[7] These principles are based largely on requirements in mutual fund rules, specifically Part 15 of National Instrument 81-102.

- calculating NAV as frequently as typically required for other investment funds;
- sensitivity around the disclosure of specific underlying hedge fund portfolio assets.

We will continue to look at ways to balance the need for transparency with the recognition that there may be unique financial disclosure issues for some hedge funds.

We will also continue to study hedge fund valuation issues, particularly:

- the role of service providers (offshore fund managers, fund administrators) in providing fund valuations or verifying fund valuations done internally;
- the policies and procedures and internal controls for valuation, for example, segregation of duties within the fund complex to mitigate any conflict of interest between those who value the funds and those who may benefit from how a fund is valued;
- the fund manager's oversight of the valuation process;
- the policies and procedures that Canadian-based funds that invest in offshore hedge funds have in place to verify valuations and other financial disclosure about those hedge funds;
- the work being done at the international level on these issues, for example, through IOSCO.

Further information
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January 12, 2007