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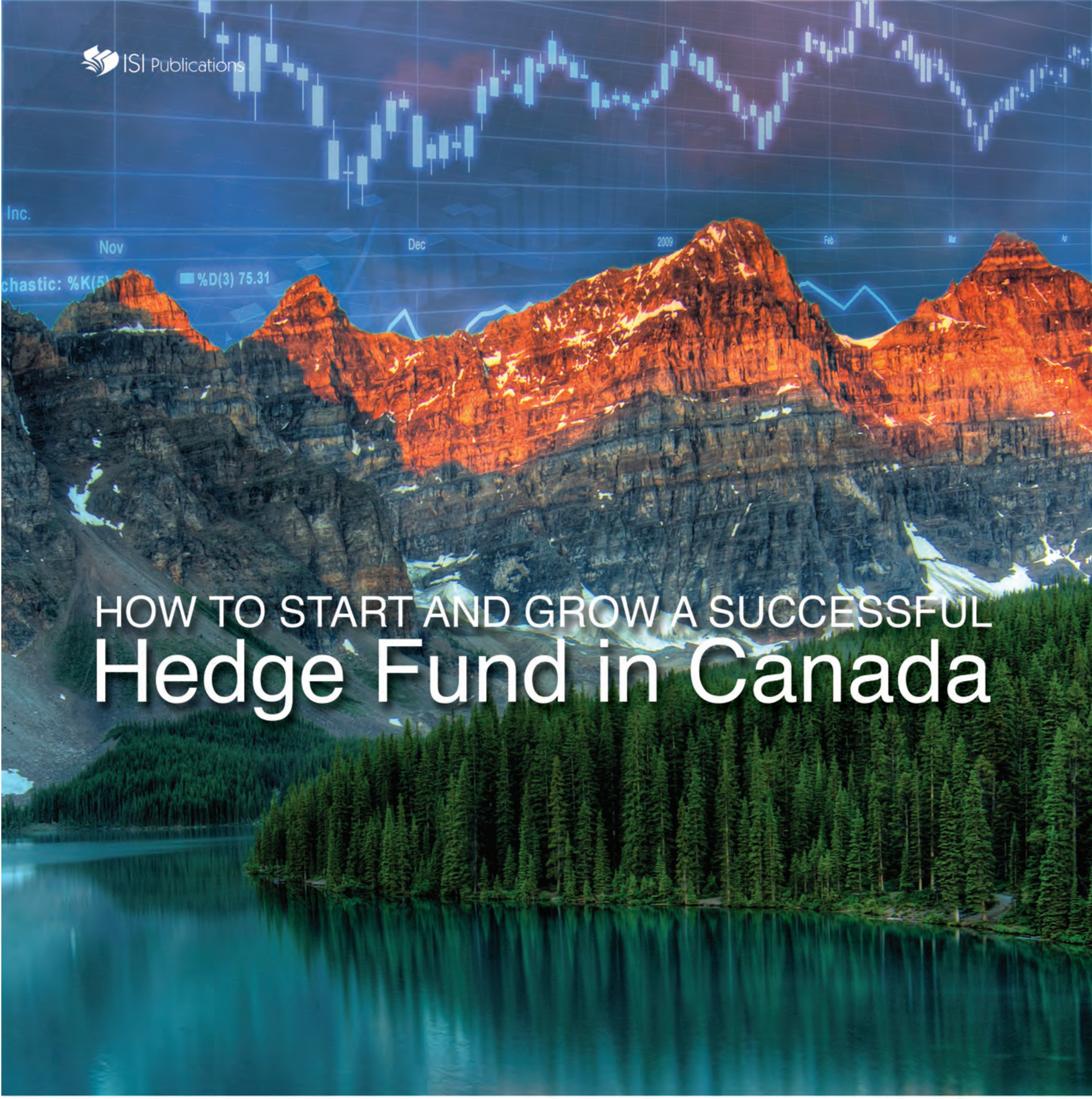

HOW TO START AND GROW A SUCCESSFUL Hedge Fund in Canada

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James Loewen
National Leader
Asset Management
T: 416-777-8427
E: jloewen@kpmg.ca

Peter Hayes
National Director
Alternative Investments
T: 416-777-3939
E: phayes@kpmg.ca

How to Start and Grow a Successful Hedge Fund in Canada

2014 Edition

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How to Start and Grow a Successful Hedge Fund in Canada

2014 Edition

This book has been compiled from the contributions of the authors indicated in each chapter, and the views expressed by such authors do not necessarily reflect the views of their respective firms.

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Chapter 1
Overview of Canada's Hedge Fund Industry

How to Start and Grow a Successful Hedge Fund in Canada

by W. William Woods, W. Woods & Co

The overall outlook for the global hedge fund industry was found to be overwhelmingly bullish in a recent survey undertaken by Credit Suisse. They estimate that global assets under management (AUM) will grow by 12%, or \$300 billion, to reach an all-time high of \$2.8 trillion by year end. Other prime brokers' surveys echo this sentiment of significant capital inflows, with the consensus being that the main impetus will be an increased interest from institutional investors.

However, the hedge fund industry in Canada is not growing at that rate. As with the investment fund industry in general in Canada, we are seeing a shortage of new entrants, and consolidation among existing players. The Canadian alternative industry is estimated to have approximately \$30 billion in AUM, and 200 fund management companies. This is down from \$32 billion in AUM at the end of 2012, and roughly the same numbers as three years ago.

It is also estimated that 70% of funds have less than \$50 million in AUM. Given the relatively slow growth of total AUM domestically over the last few years, it remains to be seen if the Canadian market can ride the growth wave predicted by the surveys in other major markets.

One of the biggest barriers to entry today is the level of regulation imposed on hedge fund managers. Understanding the requirements of NI 31-103 and the qualifications for registration can be costly and time consuming. In this new edition, you will find an informative overview of the whole process, written by Borden Ladner Gervais LLP, leading Canadian counsel for investment fund managers and one of the co-sponsors of this guide.

Despite the decline in total AUM, the skill and investment opportunities on offer in Canada should not be underestimated or dismissed by investors. A glance down the list of past winners of the annual Canadian Hedge Fund Awards–first held in 2008–bears witness to the diversity and solid performance that has been achieved across a number of strategies. Funds like AlphaNorth Partners Fund, King & Victoria Fund LP, Milford Capital Growth Fund (now the Goodwood Capital Growth Fund), JM Catalyst Fund and the various Vision Opportunity Fund LPs have won multiple awards over the last three years.

In addition, some funds are growing quickly. 'Managed Money Advisory Service: Fall 2013', a recent paper from *Investor Economics*, identifies 220% growth in the following 10 managers' AUM:

- Blackheath Fund Management
- Donville Kent Asset Management
- JM Fund Management
- K2 & Associates Investment Management
- Kensington Capital Partners
- Palos Management
- Ross Smith Asset Management
- SW8 Asset Management
- Vertex One Asset Management
- Wealhouse Capital Management

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Many successful funds are launching offshore vehicles to help attract non-Canadian assets. Maples and Calder, leading Cayman Islands counsel, have provided us with a detailed road map for Canadian managers on how to set up a Cayman fund.

One of the challenges many start-ups in Canada face is the lack of seed capital which, in other markets, is available from investment banks and/or institutional investors. This leaves most start-ups relying on 'friends and family' to get the seed capital together. The launch of Bretton Hill with $100m seed money from CALPERS was a notable exception.

Once the seed capital is raised and a good track record established, further growth in AUM requires a dedicated marketing strategy; something many managers find tough to execute both from a budget and time management perspective. It is great to see third-party capital raising services developing in Canada and this edition has been expanded to include an article on marketing by Alliance Sales and Marketing.

The principals of any new fund must carefully select their key service providers. Investors want to see who a fund's service providers are to ensure they are comfortable with the fund's infrastructure. Scotia Capital Inc.–one of the co-sponsors of this guide–have contributed a piece on the questions all funds should ask of prospective prime brokers. In a similar vein, Commonwealth Fund Services–also a co-sponsor of this guide–have addressed the issue of selecting the right fund administrator, and the process of switching administrator if deemed necessary.

Another start-up approach is for a qualified individual to seek a fund sponsor from among the larger groups that are launching new hedge funds, and look to the sponsor to raise the capital. Among the top hedge fund sponsors in Canada are: Arrow Capital Management; BlackRock; Connor Clark & Lunn; Diversified Global Asset Management; and Dynamic Funds–which collectively hold $12.4 billion in assets or 41% of the estimated total of $30.2 billion in AUM (according to *Investor Economics*). Spartan Fund Management is a different kind of firm that incubates new funds. Spartan, established in 2006, is a Toronto-based investment management company that specializes in helping experienced emerging Canadian managers that have a well-defined investment strategy and a proven track record of making money to launch new funds, using Spartan's operational, regulatory and marketing platform. Spartan has now launched eight hedge fund managers, in addition to its own multi-strategy fund.

Last but not least, we are finally seeing the emergence of successful fund of emerging hedge fund managers in Canada. Kensington Capital Partners launched the Kensington Hedge Fund One in 2012 and it now has a successful, two-year track record and over $40 million in AUM. The fund has invested with 12 managers, some in segregated managed accounts and some in fund on fund investments, so there is a diversified pool of emerging managers. The fund represents another source of assets for Canada's brightest and best new hedge fund managers.

W. William Woods
CEO
W. Woods & Co
www@wwwoods.com
Tel: 416.849.1925

Chapter 2

Structuring a Hedge Fund

How to Start and Grow a Successful Hedge Fund in Canada

by Ronald M. Kosonic and Kathryn M. Fuller, Borden Ladner Gervais LLP

Structuring a hedge fund in Canada depends on a number of factors:

- the fund's investment objective;
- the strategies the fund employs and the risks associated with those strategies;
- if it is a single-strategy fund or a multi-strategy fund;
- if it is a single manager fund or a fund of funds;
- how key individuals wish to be compensated;
- limited liability and tax considerations;
- the target investor market;
- fixed and variable costs; and
- applicable laws.

Tax, securities and commercial laws particular to Canada help shape the structure chosen and often require hedge fund products and features that are popular in the US or offshore to be modified for the Canadian market.

The term 'hedge fund' is not a legal term. It refers to the strategies employed and not to the legal characterization of the fund. For Canadian securities law purposes, pooled investment vehicles that invest in securities without seeking to actively control the issuer are referred to as 'investment funds'. 'Mutual funds' are investment funds that are redeemable on demand at their net asset value (less applicable deductions). Many hedge funds in Canada are mutual funds for securities law purposes and are regulated accordingly, although mutual funds that are sold by prospectus are subject to a set of rules that do not apply to mutual funds that are sold under private placement exemptions. Hedge funds that are not redeemable, or are subject to sufficient restrictions on redemption so as not to be considered to be redeemable on demand, are referred to as 'non-redeemable investment funds'. The terms 'hedge fund', 'fund' and 'investment fund' are used interchangeably throughout this chapter.

Fund Formation

Investment strategies and risk

Each fund structure carries different levels of risk (liability risk, tax risk and business risk) and the structure chosen depends on which factors are most important to the fund manager. Despite the name, many hedge funds carry a degree of investment risk that long-only funds do not. While a long-only fund stands to lose, at most, the value of its investments (plus any accrued but unpaid fees and expenses), hedge funds that employ leverage, sell short, invest in certain derivative instruments and/or engage in litigation-sensitive investment strategies (such as shareholder activism) can theoretically (and in some cases, quite possibly) have liabilities that significantly exceed their assets. So-called aggressive hedge funds or concentrated funds exacerbate that risk. A manager, then, may wish to adopt a legal structure that insulates fund investors from any excess liability. As discussed below, some structures offer certainty of limited liability to investors and are more appropriate for funds with investment strategies that carry a higher risk that liabilities could exceed assets.

Similarly, hedge funds may be structured in a way to achieve certain tax results for investors and/or for the principals of the fund manager. Funds that are structured to accept registered plan money, to alter the tax characterization of profits earned, to defer tax liability or to allow key individuals to share in the profits of the fund in the same manner earned by the fund (for example, as capital gains) rather than take performance fees (which are taxable as ordinary income) are exposed to varying degrees of risk of reassessment by the taxation authorities. Multi-strategy funds may wish to offer investors a tax-effective means to switch from one strategy to another, or to change the mix of strategies.

Single-strategy vs multi-strategy funds

Whether the fund manager offers a single investment strategy or multiple strategies, and whether multiple strategies are offered in a single fund or a family of related funds, also factor into the legal structure(s) chosen. A single-manager, single-strategy fund may be offered in one of three legal forms: a corporation, a limited partnership or a trust, as discussed below. The multi-strategy fund can be structured in many different ways. In its simplest form, a multi-strategy fund is managed by a single manager and all investors participate equally in one portfolio that employs multiple strategies. This structure will look very much like a single-strategy fund. Investment mix among the strategies can be fixed, or subject to maximums, in respect of the amount of the portfolio that can be allocated to any one strategy. Alternatively, the fund can operate as an 'opportunity fund' that gives the portfolio manager full discretion as investment opportunities present themselves. Multi-strategy fund managers who wish to separate strategies (or portfolio managers) have a number of options:

- a single fund, in which all investors participate, with distinct portions of the portfolio allocated to different strategies and/or portfolio managers;
- a multi-class single vehicle, with each class deriving its value from a separate pool of assets, that allows investors to choose which class(es) within the vehicle they wish to participate in;
- a series of separate funds under common administrative and portfolio management; or
- a suite of different products under common administration but engaging a third-party portfolio manager for each product.

Each separate strategy can employ the services of a third-party portfolio manager directly through a segregated account or by investing in the portfolio manager's own fund product (a 'fund-on-fund' structure). Corporate structures offering multiple strategies through different classes of shares ('switch corporations' or 'corporate class funds') can offer investors the ability to switch between investment strategies without triggering a taxable disposition (switching between funds that are not classes of the same legal entity generally triggers a taxable disposition). However, there are costs to this corporate structure (both in the form of additional expenses and potential 'tax drag' at the fund level) that may outweigh an investor's potential tax benefits. As well, cross-liability is a concern when different 'funds' are offered in the form of separate classes of the same legal entity, particularly where leverage, short sales and certain derivative strategies are employed.

Multi-strategy funds vs funds of funds

Single-manager hedge funds may follow one or more strategies. However, from an investor's perspective, there are a number of problems with direct hedge fund investing, such as conducting the required due diligence, having the expertise required for fund and manager selection, conducting appropriate risk analysis and monitoring the fund and the manager on an ongoing basis.

by Ronald M. Kosonic and Kathryn M. Fuller, Borden Ladner Gervais LLP

To diversify among various investment styles and strategies of hedge funds as well as among hedge fund managers, a multi-manager hedge fund can take the form of a 'fund of funds', providing investors with a diversified portfolio of hedge funds through investment in a single fund. The fund of hedge funds approach provides advantages over investing in single-manager funds for individuals and smaller institutional investors. As many hedge funds have high minimum investments or other investor restrictions, a fund of hedge funds provides economies of scale and permits investors to access a variety of hedge fund managers that otherwise may not be available to them. In addition, investors rely on the fund of hedge funds manager to conduct the required due diligence and to have the expertise required for fund selection, risk management and monitoring. However, a fund of funds potentially carries with it valuation, redemption and financial reporting challenges, as the underlying funds in which it invests will have varied year-ends, reporting periods, valuation dates and redemption restrictions. A fund of funds, therefore, tends to have longer redemption notice periods, higher holdbacks on redemption proceeds (pending completion of the fund's audit) and later financial reporting. The most significant downside to investing in a fund of funds is the overlaying of management fees and expenses between the fund and its underlying funds—investors must be aware of any duplication of fees and the direct and indirect expenses associated with fund of funds investing.

Compensation of managers of hedge funds

Hedge fund managers generally receive two forms of compensation: a management fee, which is typically between 1% and 2% per annum of the net asset value (NAV) of the fund; and a performance fee, which is based on the appreciation in the NAV of the fund or the securities of the fund held by an investor. Performance fees typically range between 10% and 20% of the increase in the NAV of the fund or its securities. Management fees are typically paid monthly. Performance fees are typically paid annually, however some funds pay a quarterly performance fee. Performance fees are almost always subject to a 'high water mark', so that if the fund experiences a loss, additional performance fees are not accrued until the fund's (or fund security's) NAV surpasses its previous high water mark. Hedge funds that pay a performance fee may also have a 'hurdle rate' over which the fund or fund's securities must perform (above the high water mark) before the performance fee is paid. The hurdle may provide a minimum return to investors, so that the fund manager is only paid a performance fee on any increase in NAV over the hurdle, or simply be a threshold that must be reached before the performance fee becomes payable (but calculated on the full increase in NAV over the high water mark). The hurdle may take the form of a fixed percentage or may be tied to an index or treasury bill return, depending on the nature of the hedge fund. Funds with a hurdle rate may also have a `catch-up fee' feature, which entitles the manager to receive profits over the hurdle rate until such time as it receives its 'share'. For example, if the hurdle rate is a fixed 4% of the high water mark and the performance fee is 20% of the increase in the NAV over the high water mark, then, with a catch-up fee feature, the investors are first entitled to earn their 4% of the high water mark before the manager earns any performance fee, but once the 4% has been earned, the next 1% increase in the NAV is payable to the manager as a catch-up fee (resulting in the manager receiving 20% of the first 5% increase in the NAV). If the increase in the NAV exceeds 5% of the high water mark, the investors and the manager will participate rateably (that is, on an 80/20 basis) in the excess.

Hedge fund managers may also charge an early redemption fee or deduction (which typically does not exceed 5% of the redemption proceeds), which amount is payable if the fund's securities are redeemed within the first year of their issue (or such other period as the manager may determine). The rationale for such a fee is to create a disincentive to short-term investing and to compensate the manager for its up-front costs in bringing a new investor into the fund (these costs would otherwise be absorbed over time by the fees earned from a longer-term investor). As an alternative, the early redemption deduction may be retained by the fund rather than paid as a fee to the manager.

by Ronald M. Kosonic and Kathryn M. Fuller, Borden Ladner Gervais LLP

The legal structure can influence how and to whom such payments are made. For example, where a limited partnership structure is used, the general partner may take some or all of the management and performance fees, or may take a profit-participation instead of the manager receiving a performance fee. Profit-participation may allow the general partner to receive profits in the character that they are earned by the fund, thereby receiving capital gains treatment (as an example) on some, or all, of the distributions made to it. The general partner may itself be a limited partnership, to give flexibility in the upstream sharing (by the principals and other key individuals) of the general partner's share of profits. There are tax issues related to this profit-participation structure that must be considered by the fund manager's and the investors' tax advisers.

The target market

The fund manager's target investor market will also influence the structure chosen for the hedge fund product. Hedge fund products for retail investors are quite a bit different than products for institutional investors and other purchasers in the exempt market. (`Exempt market purchasers' are those to whom the hedge fund may sell its securities without preparing a prospectus that has been filed and accepted by the applicable securities commission.) Hedge funds that are redeemable on demand (referred to as 'mutual funds') are generally not available to retail investors even if they were to use a prospectus, as securities laws applicable to retail mutual funds prohibit many of the strategies that hedge fund managers employ. Restrictions on leverage, short sales and the use of derivative investments make retail mutual funds unattractive as hedge fund vehicles. Prospectus-qualified investment funds set up as commodity pools are also not popular as hedge fund vehicles. Although they permit greater use of derivatives than their typical retail mutual fund counterparts, they still have investment and distribution restrictions that limit their market appeal. (Canadian securities regulators are currently reconsidering these restrictions.) Products such as linked notes (including principal protected notes or PPNs) have been used in Canada to give retail investors indirect exposure to different investment products and strategies, including hedge fund strategies. However, their use as hedge fund investment vehicles has diminished in the past few years as a result of regulatory scrutiny.

Even in the exempt market, a hedge fund's structure is influenced by the fund's target investors. Hedge fund managers that want to attract investment by foundations and registered tax-deferred plans are likely to choose a trust structure over a limited partnership; however, the number of investors they plan to attract will influence that decision as well. In addition, the risk appetite of target investors will determine whether a hedge fund with novel or aggressive tax planning strategies will be successful.

Applicable securities laws

As the Canadian Securities Administrators move toward harmonization of securities laws across Canada, the ability to arbitrage differences in securities laws when structuring a hedge fund has become limited. However, financial reporting requirements for privately-offered hedge funds in certain provinces of Canada are not as onerous as in others, and there has been some 'jurisdiction-shopping' by hedge fund managers in deciding where to set up their hedge funds. This is particularly the case where there are sensitivities about disclosing securities positions publicly. Differences in limited partnership laws may also cause a fund manager to prefer to set up its fund in a certain jurisdiction. Under Manitoba law, for example, the limited liability of investors who participate in advisory committees can be more certain than it is in other provinces.

by Ronald M. Kosonic and Kathryn M. Fuller, Borden Ladner Gervais LLP

Securities laws do not generally prefer one form of legal structure over another. Laws applicable to investment funds apply equally to corporations, limited partnerships and trusts.

Fund Interests

Interests in (or securities of) an investment fund may take different forms. Securities of a fund that is a corporation are referred to as shares. Securities of a fund that is a trust are typically referred to as units. Securities of a fund that is a limited partnership may also be referred to as units, but may simply be referred to as limited partnership interests, depending on the accounting practices adopted by the limited partnership.

Legal Structure of Hedge Funds

Single hedge funds in Canada can be set up using a number of different legal structures. The most appropriate structure depends on preferred tax treatment, legal liability considerations and the need for flexibility.

Corporation

Hedge funds can be set up as corporations under either provincial or federal corporate legislation. A corporation is created by the filing of articles of incorporation with the appropriate governmental authority. The affairs of the corporation are governed by the statute under which it was formed, by the articles that created it and by the general by-law(s) adopted by the director(s) and shareholder(s) of the corporation. The corporation is managed by its board of directors and by those officers that are appointed by the board. Investors subscribe for, and are issued, shares (generally pursuant to a subscription agreement) in order to become shareholders of the corporation.

The biggest advantage of the corporate structure is that it offers limited liability to investors—the most that an investor can lose is his or her investment in the corporation. For example, if short sale obligations or margin calls exceed the assets of the corporation, the corporation alone, and not its shareholders, would be liable for the difference (only in cases of fraud or other extreme circumstances would a court 'pierce the corporate veil' and hold shareholders accountable for the debts of the corporation). Corporations are also familiar to, and easily understood by, the investing public.

The disadvantage of the corporate vehicle, and what makes it an unpopular structure in Canada for hedge funds, is that federal income tax is imposed at the corporate level. Depending on the type of income or capital gains earned by the hedge fund, a corporation can be less tax efficient than other structures. In addition, there is no opportunity to flow income or losses through to the investors, which can be important to taxable and non-taxable investors.

A corporation that qualifies as a 'mutual fund corporation' under federal tax legislation can make an election that effectively treats certain income from Canadian-source investments as capital gains, which are taxed at a lower rate than ordinary income. In addition, corporations can be set up as 'switch corporations' (where each class is effectively a separate fund), allowing investors to move between investment strategies (by transferring from one class of shares to another) without triggering a taxable disposition. Finally, corporations have also been used to allow principals to take a participating interest in the growth of a fund's investment portfolio through a special class of common shares and to either leave that interest in the fund or to dividend it out.

by Ronald M. Kosonic and Kathryn M. Fuller, Borden Ladner Gervais LLP

Limited partnership

Hedge funds can also be formed as limited partnerships, with investors becoming limited partners in the partnership. Limited partnerships are formed by the filing of a certificate or declaration of limited partnership under applicable provincial legislation and the execution of a limited partnership agreement by the general partner(s) and the initial limited partner(s). The limited partnership agreement sets out the rights and obligations of the investors, much like the articles and by-laws of a corporation. The general partner is responsible for the management of the limited partnership and has unlimited liability for the debts of the limited partnership. Investors become limited partners by signing the limited partnership agreement or by agreeing to be bound by the agreement pursuant to a subscription agreement. In addition, the subscription agreement for limited partnership interests contains standard representations as to the investor's eligibility and residence, and a power of attorney in favour of the general partner that allows the general partner to sign amendments to the limited partnership agreement, to sign other documents in connection with the affairs of the partnership, and to make certain regulatory and tax filings on behalf of the limited partners.

Each limited partner has a 'limited partnership interest' in the partnership as a result of contributing capital to the fund. However, limited partnerships that are used as investment funds can be 'unitized' (meaning that a limited partner's interest is described in terms of a number of distinct units, which may be issued in different classes and/or series). Depending on the features desired in the fund and the expectations of investors, traditional capital accounting rather than unit accounting may be employed for modern hedge funds; however, the differences are more in form than in substance.

A limited partnership is similar to a corporation in that it offers statutory limited liability to each investor (provided all necessary filings have been made in the investor's jurisdiction of residence and the investor does not participate in the management of the partnership). A limited partnership has the added advantage of flowing income (or losses) directly through to individual investors so that it is taxable (or deductible) in their hands. Income may, but need not be, actually distributed to investors for this purpose. For this reason, a limited partnership can be the most tax efficient vehicle for hedge fund investors.

The ability to flow through losses, however, may be restricted in several circumstances. First, a limited partner's ability to claim losses of the limited partnership for tax purposes is limited by the 'at risk' rules. If the limited partner borrows to make an investment in the limited partnership or receives certain benefits as a result of being a limited partner, this may reduce the amount of any loss allocated to the limited partner that the limited partner can deduct against other income. Second, losses can be restricted where a limited partnership registers, or ought to have registered, as a tax shelter. Generally speaking, a limited partnership that can expect to have losses and deductions (taking into account interest expense but not taking into account any offsetting gains) in its first four years that at least equal the investors' contributed capital, ought to register as a tax shelter. There are severe penalties imposed on a promoter of a limited partnership that is required to, but does not, register as a tax shelter. Finally, if an investment in the limited partnership is a tax shelter investment, which will be the case if the partnership is a tax shelter, debt incurred by the limited partnership or by the limited partner may restrict the ability of the limited partnership and/or the limited partner to deduct losses.

by Ronald M. Kosonic and Kathryn M. Fuller, Borden Ladner Gervais LLP

The limited partnership structure may also enable the principals and other key individuals to participate in profits (both income and capital gains) through ownership of the general partner, rather than by earning a performance fee through a fund manager. Both tax and securities law considerations impact this type of profit participation structure. Flow-through tax treatment, limited liability and the flexibility afforded to limited partnerships to allocate income fairly, and to track performance and charge fees on a per unit basis, make the limited partnership a popular structure for hedge funds.

The limited partnership structure presents some drawbacks. Limited partnerships are required by applicable legislation in most provinces of Canada to register as an 'extra-provincial limited partnership' in order to raise capital in such provinces. Different naming rules in the provinces can result in a fund having to operate under another business name in a province if there is an entity with a similar name already operating in that province. In certain provinces, there is a requirement that a list of all investors in the limited partnership (including name, address and capital contribution) be filed on the public record and kept current. Other jurisdictions, while not requiring the information to be posted on the public record, require that it be provided to anyone who asks for it. Privately offered limited partnerships are generally not eligible (rather, are not made eligible) for investment by registered plans, as limited partnerships are required to be listed on a recognized stock exchange to so qualify, and the cost and bother of a public listing on a recognized stock exchange is a significant disincentive. (However, recent amendments to federal tax laws have greatly expanded the list of recognized stock exchanges, and now include certain non-Canadian exchanges that have more liberal listing and lighter reporting requirements.) Finally, the requirement that income be allocated to partners can result in an investor being taxable on income earned by the limited partnership but not actually distributed to the investor.

Trust

The third form of hedge fund vehicle is the commercial investment trust (or unit trust). Investors become beneficiaries of the trust and are generally referred to as unitholders. Commercial investment trusts are formed by the execution of a trust agreement or a declaration of trust, which sets out the rights and obligations of the trustee and the unitholders. At common law, the trustee has plenary powers to manage the trust; however, modern commercial practice is to have the trustee delegate virtually all of the management functions to a manager (unless the trustee is also the manager) and/or to a portfolio manager. For the purposes of a commercial investment trust created in Ontario, for example, a registered trust company must be engaged as the trustee unless an order is obtained from the Ontario Securities Commission permitting the fund manager to so act (managers of prospectus-qualified retail funds rely on a blanket order that permits them to serve as trustee of their funds; managers of privately-offered funds must apply for an order, which is generally granted subject to certain conditions). Individuals may act as trustees, without the need for registration or an exemption, but liability concerns discourage this practice.

Theoretically, a trust cannot offer the same degree of certainty of limited liability for investors as a corporation or limited partnership. Although the predominant view has been that, in most circumstances, the risk of liability to unitholders of a commercial investment trust is low, this issue is not settled at common law and must be considered by hedge funds that employ investment techniques that increase the risk that the liabilities of the fund could exceed its assets at a given time. Legislation in certain provinces offers narrow statutory protection for investors in public investment trust vehicles that are offered under a prospectus, but not for investors in privately-offered investment trusts.

by Ronald M. Kosonic and Kathryn M. Fuller, Borden Ladner Gervais LLP

A trust must pay tax on its income for a taxation year at the top marginal rate for individuals, but can minimize or eliminate its income and taxable capital gains by distributing its income and taxable capital gains to its unitholders, to be taxed in their hands. It is common practice for such distributions to be automatically reinvested in the trust by the issuance of additional units. As with a limited partnership, this could result in investors being taxable on income or taxable capital gains without actually receiving a cash distribution. Unlike a limited partnership, a trust cannot flow losses out to its unitholders, but can carry them forward in accordance with the normal income tax rules (however certain trust loss restriction rules may affect this ability, for example where there has been a change of majority ownership of units in the fund). A unit trust that qualifies as a 'mutual fund trust' under federal tax legislation can make an election that effectively treats certain income from Canadian-source investments as capital gains, which are taxed at a lower rate than ordinary income.

The unit trust is the preferred structure for hedge fund managers who wish to offer the fund to certain foundations, registered retirement savings plans (RRSPs) and other deferred tax plans. Trust units can be qualified for investment by registered plans if the fund qualifies as a mutual fund trust (the units must be redeemable on demand at their net asset value and the fund must have at least 150 unitholders, each holding a block of units having a net asset value of at least $500) or the fund applies under federal tax legislation to become a registered investment. The drawback of registering as a registered investment is that the fund manager is then limited as to the types of instruments the fund may invest in, and, therefore, many popular hedging techniques would not be permitted. Such restrictions do not apply to a mutual fund trust.

Layering

Layering of funds in one or more legal structures can help achieve multiple objectives.

The advantages of a trust (RRSP-eligibility, for example) can be grafted onto the advantages of a limited partnership (flexibility and certainty of limited liability) by creating a 'top trust' that invests in an underlying limited partnership where the portfolio is managed. However, there are challenges and potential drawbacks to such a structure.

Any number of top funds may be used to access different markets. A form of fund of funds popular outside of Canada is the so-called master-feeder structure, which allows two or more 'feeder funds' to invest in a single 'master fund', leaving the fund manager with a single pool of assets to manage at the master fund level. Master funds are typically set up in a tax-neutral jurisdiction such as an offshore tax haven. Feeder funds can be set up in the same jurisdiction or perhaps in the jurisdictions where the target investors reside. The use of a Canadian feeder fund in a master fund structure is hampered by the size of the market and by Canadian federal tax laws that discourage the mixing of Canadian and non- Canadian investors directly in a single pool that is managed by a Canadian fund manager.

There may be advantages to creating one investment fund as a vehicle to raise investor capital and creating another fund (a 'reference fund') in which to actively manage the investment portfolio. The first investment fund might invest in a basic investment portfolio, such as blue-chip Canadian equities, and swap returns with the reference fund through a derivative instrument such as a swap or a forward sale agreement with an institutional counterparty. Giving investors in the first investment fund a synthetic exposure to the strategies employed in the reference fund could achieve a number of business and tax objectives that a direct investment could not. There may also be tax disadvantages to such a structure.

by Ronald M. Kosonic and Kathryn M. Fuller, Borden Ladner Gervais LLP

Other Fund Features

There may be certain features of hedge funds that make the fund structure important in the Canadian market.

Classes and series of securities

Regardless of the legal structure chosen, it is common practice for hedge funds to issue securities in separate classes and separate series. In most cases, separate classes are used to allow for different fee structures or distribution rights (for example, as between institutional and smaller investors), but may also be used to reference a different pool or mix of assets. Separate series within each class may be created with each new issue of securities. Separate series are often used when a performance fee is charged based on the increase in the NAV of the fund, so that the performance fee can be separately calculated for each investor that came into the fund at the same time and deducted from the NAV of each series. In order to avoid having too many series outstanding, it is useful to collapse all of the series into one series following the payment of the performance fees. There are practical constraints and potential tax consequences in Canada that warrant caution when issuing hedge fund securities in classes and series, depending on the legal structure of the fund, the fee calculation methodology used and the desired tax consequences to investors.

Side letters and investor rights

Side letters are often requested by institutional investors that invest in a hedge fund in order to gain certain rights that might not otherwise be afforded to them under the terms of the constating documents of the fund. For example, they may wish to be given assured 'capacity' (the right to make additional investments) where the fund has a stated investment cap, to have greater transparency (regular access to statements of the fund's investment portfolio) and/or superior redemption rights. Furthermore, certain institutional investors insist on a 'most favoured nation' clause, meaning that they are to be given any superior rights afforded to other investors in the future.

The potential conflicts of interest that side letters create can be a litigation minefield for fund managers. Many of the benefits sought by the investor in a side letter can instead be given through the issue of a separate class of fund securities, provided the constating documents of the fund provide the flexibility to do so. In either case, it is considered inappropriate to offer an investor or class of investors greater transparency rights and greater liquidity (that is, more frequent redemption dates or shorter notice periods) than other investors, as the preferred investors could learn of a problem and redeem out of the fund before the other investors even know there is an issue, leaving the fund manager potentially exposed to liability.

Side pockets

Side pockets have become a useful tool for dealing with illiquid investments within a relatively liquid portfolio, particularly for investment funds that are in continuous distribution and offer redemption on demand or with relatively short notice periods. Illiquid investments can be isolated (put into 'side pockets') and valued separately from the main body of investments in a fund's portfolio. When investors redeem their interest in the fund, they receive immediate proceeds based on their respective interest in the main pool of fund assets, but they must wait

by Ronald M. Kosonic and Kathryn M. Fuller, Borden Ladner Gervais LLP

until any side pocket investments are realized or otherwise become liquid (which could take months or years) before they receive the value of their respective interest in those side pockets. Side pocket interests may be represented by a separate class of securities (one for each illiquid interest) or may be embedded in the main class of fund securities held by investors. Some funds allow investors to elect whether or not to participate in side pockets. As each side pocket investment becomes available, only investors who are in the fund at that time will participate in the investment. Future investors, whether 'participating' or 'non-participating', do not acquire an interest in the existing side pocket. The value of a side pocket investment is typically carried at cost and is only revalued when a 'valuation event' occurs for accounting purposes.

Transparency, liquidity and control

There has been, since the market crisis of 2008, a movement in the international hedge fund community to address investor concerns regarding transparency, liquidity and control over investment assets by substituting or complementing their investment fund products with segregated account portfolios, single-investor funds and other individualized investment platforms. This trend has not been as prevalent in Canada simply because there are relatively few investors who can allocate, to a single manager, investment assets large enough to justify managing those assets on a segregated basis. Investment funds historically have been a popular tool of investment managers who wish to manage a single pool of assets, rather than multiple pools, and to take advantage of the economies of scale that a pooled investment vehicle can provide. Investment funds also provide investors with an opportunity to diversify their holdings. Those factors still favour the creation of hedge funds as investment vehicles for Canadian investors who wish to access alternative investment strategies, however, hedge fund products available to the Canadian market today tend to have greater transparency and liquidity than they did prior to 2008.

Fund Management Complex

In addition to considering the structure of the fund itself, the manager must also decide on how fund management services will be provided to the fund and how the entities involved will be owned. The fund structure chosen by the fund manager may reflect a number of factors, including tax planning at the management level, in-house expertise and infrastructure, regulatory considerations and the principals' appetite for legal and operational complexity in structuring their affairs.

In its simplest form, a hedge fund complex will consist of the fund itself and the fund manager, who provides all of the necessary services to the fund, including distribution, administration and portfolio management. To the extent that other service providers are retained, they may offer their services either to the fund manager or directly to the fund. How the fund manager is owned will depend on the personal tax needs of the principals and whether their business plan contemplates future strategic partners or possible equity-sharing with key employees.

Whether a single entity or multiple entities are used to provide the necessary services generally depends on two factors: whether the fund manager has the internal expertise to provide the service and whether the manager (assuming it has the internal expertise) wishes to separate its fund management responsibilities from its portfolio management responsibilities and/or fund distribution responsibilities. As all of these activities are now subject to registration in Canada, it is more common than it was even just a few years ago for a single entity to provide fund management, portfolio management and fund distribution services, rather than having affiliates carry out separate services. Capital, insurance and infrastructure requirements imposed by Canadian securities laws on registered entities discourage the use of multiple related entities.

by Ronald M. Kosonic and Kathryn M. Fuller, Borden Ladner Gervais LLP

Limited partnerships–a magic bullet?

There had been a common misconception in the Canadian marketplace that if the general partner of a limited partnership makes investment decisions on behalf of the partnership, the general partner is not required to register with the securities regulators. This view caused many hedge funds to be formed as limited partnerships in Canada without seeking registration in any category and without hiring a registered adviser. Fund managers who followed this advice in the past did so at their own peril. The Canadian Securities Administrators have effectively settled this issue by publishing their position that, regardless of the legal structure chosen, any person or company making discretionary investment decisions on behalf of a pooled entity that was formed for that very purpose is required to register as a portfolio manager with the applicable securities commission. Furthermore, changes in securities laws in Canada expanded the categories of registration in which a general partner may have to be registered, to include those of 'investment fund manager' and 'dealer'. It is therefore typical in the investment fund industry in Canada for a general partner of a limited partnership to outsource all registerable activities to a manager that is properly registered in all necessary categories and all necessary jurisdictions in Canada.

Ronald M. Kosonic
Partner
Borden Ladner Gervais LLP
rkosonic@blg.com
Tel: 416.367.6621

Kathryn M. Fuller
Partner
Borden Ladner Gervais LLP
kfuller@blg.com
Tel: 416.367.6731

Chapter 3

Registration in Canada

How to Start and Grow a Successful Hedge Fund in Canada

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by Prema K. R. Thiele, Laurie J. Cook and Matthew P. Williams, Borden Ladner Gervais LLP

Introduction

In Canada, securities matters are subject to the jurisdiction of the various Canadian provinces and territories. While each jurisdiction has its own securities legislation, there is a single, harmonized registration and compliance regime in place across Canada called National Instrument 31-103 *Registration Requirements, Exemptions and Ongoing Registrant Obligations* (NI 31-103). Accordingly, depending on the nature and location of the activities involved, the legislation of one or more Canadian jurisdictions may require market participants to be registered with the local securities regulator.

In general, those who advise others in respect of investing in securities must be registered as an adviser, or an advising representative of a registered adviser, or be exempt from the adviser registration requirement. Practically speaking, the permitted exemptions from the requirement to register as an adviser are limited. As a result, the adviser registration requirement is usually unavoidable. Although each Canadian jurisdiction regulates securities and commodity futures similarly, the Provinces of Ontario and Manitoba regulate securities and commodity futures through separate statutes. Those who advise in respect of commodity futures contracts and commodity futures options in those provinces must be separately registered as advisers under the commodity futures legislation of those jurisdictions, or be exempt from that registration requirement. In addition, the Province of Québec has a Derivatives Act and care must be taken to determine whether an additional registration is required under this legislation.

Any person or company that is in the business of trading in securities must also be registered as a dealer, or a dealing representative of a registered dealer, or otherwise be exempt from the dealer registration requirement (see *Exemptions from dealer registration and referral fees*, below). There are a number of factors that must be examined to determine whether you are in the business of trading in securities, none of which is determinative, including engaging in activities similar to a registrant, intermediating trades or acting as a market maker, directly or indirectly carrying on the activity with repetition, regularity or continuity, being, or expecting to be, remunerated or compensated and directly or indirectly soliciting securities transactions.

Trading in securities includes, among other activities, 'any sale or disposition of a security for valuable consideration' and 'any act, advertisement, solicitation, conduct or negotiation, directly or indirectly, in furtherance' of any sale or disposition of a security. The definition of 'trading' is extremely broad. It includes the solicitation or servicing of prospective investors or existing investors in respect of any trading activity. Certain activities, including back office, administrative and book-keeping functions generally do not constitute trading and, accordingly, may not require registration.

Finally, since the vast majority of hedge funds are 'investment funds', registration as an investment fund manager will be required for most firms within a typical hedge fund set up. That is, where there is an investment fund, there must be an entity which 'directs the business, operations or affairs' of that investment fund. This is the registration trigger for investment fund manager registration. The investment fund manager registration category is described in more detail below.

Registration in Canada

How to Start and Grow a Successful Hedge Fund in Canada

by Prema K. R. Thiele, Laurie J. Cook and Matthew P. Williams, Borden Ladner Gervais LLP

In this chapter, wherever possible, we will discuss registration issues from the perspective of Ontario securities laws, unless the laws of another Canadian jurisdiction are substantively different. NI 31-103, as more fully outlined below, is designed to put in place a nationally harmonized and streamlined registration regime.

Key Registration and Compliance Concepts in Canada

NI 31-103, in force as of 28 September 2009, has significantly altered the *status quo* for financial services firms doing business in Canada. NI 31-103 covers the requirements for firms and individuals to become registered with the various securities commissions, and regulates certain registrant activities in Canada, such as referral arrangements and client relationships. NI 31-103 has expanded or clarified existing regulation of hedge fund managers, advisers and distributors by:

- requiring registration for 'investment fund managers';
- requiring registration for 'exempt market dealers';
- introducing a 'business trigger' test for determining when registration as a dealer is required;
- increasing capital and insurance requirements across all categories of registration;
- changing proficiency (ie. exam) requirements for all individual registrants;
- introducing requirements for handling complaints and conflicts of interest;
- enhancing compliance and supervisory expectations;
- governing referral arrangements; and
- increasing financial reporting requirements.

The following summarizes the key registration and compliance issues in NI 31-103.

Registration of investment fund managers

Under NI 31-103, investment fund managers are required to become registered as such, generally, in each province or territory where the person or company that directs the management of the fund is located, if this is in Canada (in most cases where the head office of the fund manager is located). This registration rule applies to all managers of investment funds, including funds that are reporting issuers and those that are privately offered. The term 'investment fund manager' is defined as 'a person or company that directs the business, operations and affairs of an investment fund'.

In addition to the general registration requirement for investment fund managers in NI 31-103 noted above, in September 2012, two additional yet disparate approaches were brought into force for registration of investment fund managers. The two sets of rules, outlined in more detail later on in this chapter, determine when investment fund managers must register in the other jurisdictions of Canada, other than where the mind and management of the fund is located. These two new regulatory regimes apply to both Canadian investment fund managers and investment fund managers resident outside of Canada that do not direct the management of the fund from inside Canada.

by Prema K. R. Thiele, Laurie J. Cook and Matthew P. Williams, Borden Ladner Gervais LLP

Exempt market dealer registration

The category of 'exempt market dealer' has replaced the 'limited market dealer' category in Ontario and Newfoundland and Labrador and, under NI 31-103, applies across Canada (with few exceptions, such as in certain provinces and the territories where exemptions will be available for purely 'local' market participants). Unlike limited market dealers, a registered exempt market dealer is subject to minimum capital, insurance and proficiency requirements for its dealing representatives and its chief compliance officer (CCO). Also, depending on the type of client, exempt market dealers are subject to enhanced 'know-your-client', suitability and client reporting requirements.

Registration exemptions and the 'business trigger'

Pre-NI 31-103 securities legislation imposed a 'business trigger' only for determining whether an entity was required to be registered as an adviser (ie. whether the market participant was or held itself out as being in the business of advising others as to the buying and selling of securities). In contrast, the dealer registration requirement was triggered by an entity simply participating in a trade. Under NI 31-103, the business trigger has been expanded to include dealers, such that persons or companies that are in the business of trading in securities will be required to obtain registration as a dealer in any and all provinces and/or territories where clients are located. There are certain exemptions in NI 31-103 from the requirement to register as a dealer of which hedge funds may be able to avail themselves.

Capital and insurance requirements

Minimum capital under NI 31-103 for investment fund managers is $100,000; for dealers, $50,000; and for portfolio managers, $25,000. Generally, the required capital will be adjusted upward to reflect total assets or assets under management, deductibles under required insurance policies and other risk-related factors. For firms registered in more than one category, these minimums will not be cumulative. Minimum insurance requirements under NI 31-103 can be significant for firms with substantial assets or assets under management; up to $25 million in some cases. Dealer firms that are members of a self-regulatory organization (SRO) such as the Investment Industry Regulatory Organization of Canada (IIROC) or the Mutual Fund Dealers Association of Canada (MFDA) will continue to comply with the respective SRO's capital and insurance requirements.

Conduct rules

Under NI 31-103, a registered firm is required to establish and enforce a system of controls and supervision that ensures the firm's compliance with all applicable requirements. This system of controls must be documented in the form of written policies and procedures. The registered firm is also required to ensure that its compliance monitoring and supervision policies and procedures take into account conflicts of interest management issues. To the extent that certain duties (eg. back-office administration) are delegated to third-party service providers, the registrant firm principally charged with the responsibility is required to conduct appropriate due diligence on all such service providers and to regularly monitor their activities. Ultimate responsibility for the actions of the service providers will remain with the registrant.

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Registration Requirements

Adviser registration

Any person or company who provides investment advisory services to an investment fund such as a mutual fund or hedge fund generally must be registered or exempt from registration as an adviser in the jurisdiction in which the investment fund is established. The 'look through' theory of registrable activity that, prior to NI 31-103, resulted in the determination in certain provinces that the adviser entity needed to be registered in circumstances where it advised an investment fund whose securities were distributed in that particular province, has been eliminated under NI 31-103. Accordingly, the Ontario Securities Commission (OSC) no longer takes the view that an adviser entity which provides investment advisory services to an investment fund that distributes its securities in Ontario is indirectly advising Ontario investors.

An entity which is acting as an adviser in respect of securities in Ontario (and where an exemption from the registration requirement is unavailable) is required to register in one of the following categories of adviser registration:

Portfolio manager

Under NI 31-103, an adviser must register as a portfolio manager in the relevant jurisdiction(s) of Canada in order to provide advisory services to any person or entity resident in that particular jurisdiction (the equivalent categories under the commodity futures legislation of Ontario are commodity trading counsel and commodity trading manager). An adviser so registered has no restrictions on the types of clients or securities that it may advise.

Under NI 31-103, the adviser entity is required to meet certain proficiency, insurance and capital requirements in order to obtain registration. An adviser entity will only achieve registration if it has both an advising representative and a CCO who each meet the specified proficiency requirements for their category of registration. Exemptive relief can be sought if it can be established that the advising representative or CCO has comparable education and experience to that required.

For non-Canadian entities, registration as a portfolio manager is granted on the basis of compliance with all other usual requirements applicable to advisers resident in Canada, as well as additional requirements including the appointment of an agent for service in the relevant jurisdiction(s) of Canada, requiring client funds and securities to be held either by the client or by a custodian that satisfies prescribed requirements, submission to the non-exclusive jurisdiction of the courts of the jurisdiction(s) of Canada, and disclosure of the adviser's non-resident status to its clients.

Restricted portfolio manager

Under NI 31-103, there is an adviser registration category of 'restricted portfolio manager', being a person or company whose business is subject to conditions of registration that limit their advising activities (for example, they may be limited to advising in respect of a specific type of security or in respect of securities of issuers within a specific industry). The relevant securities regulator will decide on a case-by-case basis what education and experience are required for registration as an advising representative or CCO of a restricted portfolio manager. This category of registration may be appropriate where, for example, a hedge fund will limit its investments to a specific area, such as securities of oil and gas issuers or mining issuers.

by Prema K. R. Thiele, Laurie J. Cook and Matthew P. Williams, Borden Ladner Gervais LLP

Exemptions from adviser registration

Sub-adviser exemption

Currently, an advising entity that is not ordinarily resident in Ontario is exempt from the adviser registration requirement in Ontario if the adviser entity acts as a sub-adviser to an adviser that is registered under Ontario securities law, provided that the adviser entity enters into a sub-advisory agreement with the registered adviser and the registered adviser agrees to assume responsibility for the advice provided by the sub-adviser. Québec has similar statutory relief, and the remaining provinces and territories will generally grant relief on terms similar to the Ontario and Québec exemptions on a discretionary basis upon application.

Proposed amendments to NI 31-103 slated to come into force in late 2014 or early 2015 would harmonize this approach into a formal sub-adviser exemption in NI 31-103 that would exempt such entities from adviser registration on terms similar to the Ontario statutory relief.

International adviser exemption

Under NI 31-103, a non-Canadian adviser that provides advice on non-Canadian securities (or Canadian issuers where that advice is incidental to its providing advice on a non-Canadian security) may avail itself of an exemption from adviser registration in certain circumstances. This 'international adviser exemption' permits a firm that is registered as an adviser in its non-Canadian 'home' jurisdiction to carry out specified activities in Canada, primarily with 'permitted clients' (a subset of 'accredited investors' and essentially comprising large institutions such as banks and trust companies, government agencies, pension plans, investment funds managed or advised by a registrant, companies with net assets of at least $25 million and super high-net worth individuals), other than registered advisers or dealers, subject to certain conditions.

To the extent that the above adviser exemptions are not specifically granted for the purpose of commodity futures legislation, or in the other Canadian jurisdictions, such relief can generally be obtained on a discretionary basis upon application (and subject to the same terms and conditions as the respective adviser or sub-adviser exemptions).

There are certain other limited exemptions available from the adviser registration requirement which may be available.

Dealer registration

Investment funds are intermediary vehicles that operate between the adviser entity and the investor. When an investor purchases the securities of an investment fund, a trade is effected and the nature of the services being provided directly to the investor changes from that of 'advising on' to that of 'trading in' securities. An adviser entity generally need only register as an adviser in the jurisdiction in which the fund is established. In contrast, in the case of investment funds, only dealers registered in the jurisdiction(s) where an investor is resident or domiciled may effect trades for such investors, unless an exemption from registration is available or a discretionary order has been obtained.

A hedge fund offering its securities in Ontario must determine whether the fund's investment fund manager (or other entity involved in the distribution of the fund's securities) must register as a dealer or whether a third-party dealer must be engaged. The category of dealer registration required for any intermediary would be dependent on the particular security being distributed. In connection with the sale of hedge fund securities in Ontario, a market intermediary would have to be registered under one of the following categories of registration:

by Prema K. R. Thiele, Laurie J. Cook and Matthew P. Williams, Borden Ladner Gervais LLP

Exempt market dealer

In Canada, hedge funds will have to register as an exempt market dealer in every province and territory where they wish to market and sell their funds, unless they engage a dealer that is registered in the prospective purchaser's province or territory. Unlike the old `limited market dealer' category in Ontario and Newfoundland, a registered exempt market dealer is subject to minimum capital and insurance requirements, as well as proficiency requirements for its dealing representatives and its CCO. Exempt market dealers are subject to 'know-your-client' and suitability requirements, except in respect of trades to certain `permitted clients' who waive those requirements. This category of registration only permits the dealer to participate in exempt trades (that is, trades for which an exemption from the prospectus requirement is available), but is sufficient and most often relied upon for the private placement in Canada of hedge fund securities. Exempt market dealers may also market, sell and distribute prospectus-qualified funds, though only to 'accredited investors' (or pursuant to some other prospectus exemption available on the distribution).

Mutual fund dealer

Market participants who wish to sell securities of hedge funds that qualify as mutual funds (generally any investment pool whose securities are redeemable on demand at their net asset value) and that are offered by prospectus, may apply for mutual fund dealer registration if they wish to sell their funds to investors that do not qualify as 'accredited investors'. In Ontario, this requires registration with the OSC and membership with the MFDA. In addition to proficiency requirements for the dealer's salespersons, the dealer is required to carry minimum capital and insurance, prepare and file audited financial statements annually, operate under a set of approved policies and procedures and keep certain books and records.

Investment dealer

This category of dealer registration is unrestricted and permits a dealer to sell any type of security, including mutual fund securities and exempt hedge fund products (whether offered pursuant to a prospectus or by private placement). To obtain such registration with the OSC, one must concurrently become a member of IIROC. Investment dealers are generally held to higher proficiency, capital and insurance requirements than are mutual fund dealers because of the broader range of products and services an investment dealer may provide; however, these requirements will differ depending on the level of membership obtained

All IIROC members must prepare and file audited financial statements, operate under an approved set of written policies and procedures and maintain prescribed books and records.

Individuals in an IIROC member firm can be recognized by IIROC as portfolio managers if they meet prescribed proficiency requirements (similar to those for advising representatives of adviser firms), which would allow them to have discretionary trading authority over client assets. For this reason, some investment fund managers obtain investment dealer registration and become IIROC members to permit them to provide the full range of services to the investment funds they manage, from distribution of the fund's securities to management of the fund's portfolio.

Exemptions from dealer registration and referral fees

There are several exemptions from the dealer registration requirements outlined in NI 31-103. The most relevant of these to a hedge fund is the so-called 'managed account exemption', which permits an entity registered as an adviser to trade securities of its own investment funds (pooled or prospectus-qualified) to the managed account of a client of the adviser without having to become registered as an exempt market dealer, provided the adviser acts as the fund's adviser and its investment fund manager.

by Prema K. R. Thiele, Laurie J. Cook and Matthew P. Williams, Borden Ladner Gervais LLP

NI 31-103 requires all referral arrangements to be in writing and clearly allocate responsibility for discharging regulatory duties, such as know-your-client and suitability requirements. Registrants must ensure that investors are fully informed of all such arrangements and the payments made under them (whether the actual payment or the method of calculation).

Hedge fund managers and their registered affiliates who enter into agency or referral arrangements with other entities (be they registrants or non-registrants), even in respect of the distribution of fund securities pursuant to prospectus and registration exemptions, should consult with legal counsel in Canada where they propose to make such payments to determine whether they are in compliance with NI 31-103.

Investment fund manager registration

As noted above, investment fund managers are required to become registered as such, generally, in each province or territory where the person or company that directs the management of the fund is located, if this is in Canada (in most cases where the head office of the fund manager is located). This registration rule applies to all managers of investment funds, including funds that are reporting issuers and those that are privately offered.

However, on 28 September 2012, a new rule came into effect in Ontario, Québec and Newfoundland & Labrador that requires an investment fund manager–whether foreign or domestic–to register in one or more of these provinces if its investment funds are distributed there, subject to certain exemptions. Multilateral Instrument 32-102 *Registration Exemptions for Non-Resident Investment Fund Managers* provides two limited exemptions from investment fund manager registration, generally in circumstances where there are no significant connecting factors to the applicable province. The two exemptions in MI 32-102 are the 'grandfathering' exemption and the 'permitted client' exemption.

The 'grandfathering' exemption provides an exemption for an investment fund manager without a place of business in the relevant province if: (i) the investment funds have no securityholders resident in the relevant province; or (ii) neither of the investment fund manager nor its investment fund(s) actively solicits residents in the relevant province to purchase securities of the investment fund(s) at any time after 27 September 2012. The concept of 'active solicitation' is discussed in the Companion Policy to MI 32-102 and includes 'intentional actions' taken by a fund or the investment fund manager to encourage purchases of the investment fund's securities, such as pro-active, targeted actions or communications that are initiated by an investment fund manager for the purpose of soliciting an investment.

The 'permitted client' exemption provides an exemption–for a non-Canadian investment fund manager only–where the investment fund manager distributes its investment fund(s) in a province solely to 'permitted clients' (as such term is defined in NI 31-103), where those 'permitted clients' acquire(d) the investment fund(s) pursuant to applicable prospectus exemptions in the province. Canadian hedge fund managers cannot avail themselves of the 'permitted client' exemption and would have to seek full registration as an investment fund manager in one or more of the above provinces if it could not rely on the 'grandfathering' exemption.

There are several conditions attached to the 'permitted client' exemption including that: (i) the investment fund manager does not have its head office or principal place of business in Canada; (ii) the investment fund manager is created under the laws of a non-Canadian jurisdiction; (iii) none of the investment fund manager's investment funds is a reporting issuer in any jurisdiction of Canada; (iv) before relying on the exemption in a province, the investment

by Prema K. R. Thiele, Laurie J. Cook and Matthew P. Williams, Borden Ladner Gervais LLP

fund manager files the appropriate exemption election forms with the securities regulatory authority; and (v) the investment fund manager provides its 'permitted clients' with certain disclosure regarding its non-resident status. In addition, to continue to rely on this exemption, the non-Canadian investment fund manager must make regular filings with the applicable regulator.

The remaining provinces and territories of Canada have issued a separate policy regarding registration of investment fund managers – Multilateral Policy 31-202 *Registration Requirement for Investment Fund Managers* – that, rather than containing exemptions from the registration requirement, contains guidance on when an investment fund manager is required to register in those jurisdictions. Typically, these would include a substantial connection to the relevant jurisdiction, such as directing or managing the business, operations or affairs of the fund from a physical place of business in one of these jurisdictions. Investment fund manager registration will not be required solely because of the presence of fund investors in a jurisdiction and/or the solicitation of investors in a jurisdiction. If the factors requiring registration under MP 31-202 are present, no exemption is available.

Exemptions from investment fund manager registration

Other than the 'grandfathering' and 'permitted client' exemptions noted above, there are no exemptions from the requirement to register as an investment fund manager that would be practically available to managers of hedge funds in Canada.

Prema K. R. Thiele
Partner
Borden Ladner Gervais LLP
pthiele@blg.com
Tel: 416.367.6082

Laurie J. Cook
Partner
Borden Ladner Gervais LLP
lcook@blg.com
Tel: 416.367.6639

Matthew P. Williams
Partner
Borden Ladner Gervais LLP
mwilliams@blg.com
Tel: 416.367.6261

Chapter 4

Keeping Current withYour Compliance Obligations

How to Start and Grow a Successful Hedge Fund in Canada

by Lynn M. McGrade and Sarah K. Gardiner, Borden Ladner Gervais LLP

Introduction

The purpose of this chapter is to provide an overview of the compliance obligations of a hedge fund manager in respect of the hedge fund it manages. This chapter does not discuss the specific compliance obligations that a hedge fund manager may have in its capacity as a registrant. For example, we will not discuss the obligations of an investment fund manager, dealer or adviser (or commodity trading manager) in this chapter; however, under Canadian securities laws, a hedge fund manager may be required to register in one or more of those categories. You will find more information about the regulatory framework in Canada for investment fund managers, dealers and advisers elsewhere in this publication. In addition, we have not specifically addressed the regulatory framework for the distribution of hedge fund securities in Canada because that topic also has been addressed elsewhere in this publication. It is important to note the currency of the information provided herein, because of changes to securities legislation which will come into effect over the next few years including in connection with a current review being conducted by various Canadian securities regulators of the exempt marketplace.

We may make reference in this chapter to an 'investment fund', a regulatory term that includes what is generally called a 'hedge fund'.

Provincial Securities Regulations

Before delving into the actual compliance issues for hedge funds in Canada, it is important to understand the regulatory framework in which they are formed. Canada does not currently have a national regulator (such as the SEC) and does not have a uniform national securities act. Each province/territory of Canada has its own securities regulator, provincial/territorial securities act, regulations, rules and policies. However, in an effort to reach consensus and harmonization on certain matters that are of national concern, the Canadian Securities Administrators (CSA), representing each of the provincial regulators, have adopted national instruments (applicable nationwide) and multi-lateral instruments (applicable in more than one, but not all, provinces or territories). There are, for example, national instruments that regulate investment funds that are reporting issuers. As well, as noted below, there is a specific national instrument that regulates the continuous disclosure obligations of investment funds, both reporting issuers and certain non-reporting issuers. In addition, in a major initiative to harmonize the registration regime across Canada, the CSA have adopted a national instrument regarding registration requirements, exemptions and ongoing registrant obligations.

Although all Canadian securities legislation is premised on the two themes that securities may only be distributed pursuant to a prospectus unless a prospectus exemption is available, and that a registered dealer must be engaged to sell the securities unless a registration exemption is available, and although the CSA have adopted national instruments to harmonize these exemptions, there remain some differences in each province/territory with the prospectus and registration exemptions that are available. As a result of this patchwork approach to securities regulation in Canada, a hedge fund manager must consider the securities laws in the province/territory where its fund is formed and managed, and in each province/territory where the securities of the fund are sold, in order to understand its compliance obligations as manager of the investment fund.

We will primarily focus this chapter on the requirements that apply in the province of Ontario and will note any substantive differences that may exist in the other Canadian provinces/territories. We recommend that you seek advice from legal counsel for the specific rules that may apply if you plan to distribute securities in any province or territory of Canada.

Keeping Current with Your Compliance Obligations

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by Lynn M. McGrade and Sarah K. Gardiner, Borden Ladner Gervais LLP

Different Structures, Different Obligations

Public versus private

In Canada, the majority of hedge funds are offered in the exempt market, although there are a few funds currently being offered by prospectus (the retail market). A 'prospectus' is an offering document that is subject to regulatory requirements as to content, and is filed with and reviewed and officially `receipted' by one or more securities regulators in Canada.

In contrast, an 'offering memorandum', which is typically used in an exempt offering, generally has no mandated disclosure requirements and although it may have to be filed with certain securities regulators it is neither reviewed nor receipted by them. The few hedge funds that have been offered by prospectus in Canada are typically redeemable once per year at most, and achieve liquidity for their securityholders by becoming listed on a recognized stock exchange, primarily the Toronto Stock Exchange. Issuers, including investment funds, that sell or have sold their securities by prospectus and/or list their securities on a Canadian stock exchange become 'reporting issuers' under Canadian securities laws and are subject to continuous disclosure and regulatory compliance requirements.

By limiting redemptions to once annually, these prospectus-offered hedge funds are outside the application of the national rules for mutual funds (that is, investment funds that are redeemable on demand) that offer their securities by prospectus and, as a result, their investment strategies are not restricted by the investment and concentration restrictions generally applicable to retail mutual funds (although there are pending proposals to adopt certain core investment restrictions and operational requirements for all prospectus–offered investment funds). In the case of a 'reporting issuer' hedge fund, in addition to the compliance obligations summarized in this chapter, there would also be obligations under the securities rules that apply to the delivery of a prospectus, the sale of prospectus-offered securities and the rules of the applicable stock exchange. As well, governance rules require investment funds that are reporting issuers to appoint an independent review committee, a body designed to review and in many cases approve transactions in which the fund manager is actually or potentially conflicted in interest.

As noted above, the majority of hedge funds in Canada are offered in the exempt market. The result is that hedge funds are generally only available for sale to more sophisticated purchasers who are permitted to purchase securities without a prospectus. The exempt market is intended to provide issuers, including investment funds, with access to capital from high net worth and institutional investors without the heavy disclosure burden of a prospectus offering and without the on-going compliance burden and continuous public disclosure obligations of being a reporting issuer.

Corporations, trusts and limited partnerships

Both public and privately-offered investment funds may be structured in one of three ways: as a corporation, as a trust or as a limited partnership. Generally, the decision as to structure is heavily influenced by the tax outcomes and efficiencies that the investment fund is trying to achieve, including eligibility for registered plans (including RRSPs), the ability to include a capital carry component as part of the hedge fund manager's remuneration, the flow through of income and capital gains from the investment fund to its securityholders and the flow through of losses to the investment fund's securityholders. Because corporations are the least efficient structures to achieve income

by Lynn M. McGrade and Sarah K. Gardiner, Borden Ladner Gervais LLP

and capital gains flow through, they are seldom used in Canada to structure hedge funds. The tax implications of and other considerations for these structures are discussed in more detail elsewhere in this publication.

Trusts

A trust is an entity that is created by contract, either by declaration of trust (if the manager is the trustee) or by trust agreement (if an institutional trustee is the trustee). This trust document will set out the nature of the trust, powers of the trustee and the rights and obligations of its unitholders. In order to settle the trust, the trustee must sign the trust document and put some money or something of value in the trust (as little as $10, typically). In some provinces, such as Ontario, an approval may be required to be obtained from the securities regulator for the manager to act as trustee of an investment fund. Each trust is governed by the laws of the jurisdiction in which it is created, which includes, in Ontario, a body of common law (judge-made law). To change the trust document, the trustee must comply with the provisions relating to amendments set out therein with regard to prior written notice and/or securityholder approval.

The trust document is not filed with any regulatory body. The trust must file tax returns and relevant elections in accordance with the tax rules that apply to trusts that are investment funds, and must report to unitholders the amount of all distributions made to them in the year (which are typically automatically reinvested in additional units of the fund, meaning that unitholders will not necessarily receive the distributions for which they are taxable). The tax year-end of a trust that is an investment fund must be 31 December, although it may elect to have a different fiscal year-end for other purposes.

Limited partnerships

Many hedge funds are organized as limited partnerships. A limited partnership is established by contract (a limited partnership agreement) between a general partner (often a corporation) and the limited partners (the investors). The limited partnership agreement generally sets out the nature of the limited partnership, the powers of the general partner and the rights and obligations of the limited partners. To the extent that the limited partners comply with the limited partnership agreement and the provisions of the limited partnership legislation in the province in which the limited partnership is formed, the liability of each limited partner will be limited to the contribution that they make to the partnership (subject to any additional specific liability they agree to incur in the limited partnership agreement).

A limited partnership must register as an extra-provincial limited partnership in each Canadian province in which it intends to carry on business, and the general partner, if a corporation, must also be registered in certain of such jurisdictions. It is important to complete these registrations prior to selling interests in the limited partnership in the province, because this is generally considered to be 'carrying on business' in most Canadian provinces. There are forms to be completed and fees to be paid in connection with this registration process and the registry office in certain jurisdictions require a copy of the limited partnership agreement for its files. To the extent that the general partner or the limited partnership makes changes to its name, head office or certain other administrative changes, these must be reported to the relevant registry office. In certain jurisdictions, changes in the limited partners (which is likely if the fund is in continuous distribution and/or redeemable on demand) must also be reported to the relevant registry office.

by Lynn M. McGrade and Sarah K. Gardiner, Borden Ladner Gervais LLP

A limited partnership is not itself subject to federal income tax, but must report its taxable income and gains (and/or losses) to the Canada Revenue Agency. It must also make allocations of such income/gains/ losses to its partners, and report such allocations to the partners for tax purposes.

In addition, since the general partner itself is typically a corporation, it will be subject to any required corporate and tax filings applicable to a corporation in the jurisdiction. In Ontario, there is an annual tax return that must be filed and an annual corporate filing which must be made. If there are changes to the directors or officers at any time, there is also a requirement to file a notice.

Reporting Requirements for Hedge Funds

No matter what structure a hedge fund manager chooses for its hedge fund, there are certain reporting requirements imposed by the securities laws that apply to investment funds, including those that are offered in the exempt market, depending on the jurisdiction of their formation and whether they have a redemption-on-demand feature. These include the following:

- Annual and semi-annual financial reporting. There are two levels of filing obligations for investment funds: one for reporting issuers; and one for funds offered in the exempt market. Investment funds organized under the laws of British Columbia, Alberta, Manitoba or Newfoundland and Labrador that are not reporting issuers are not subject to these rules at all, nor are investment funds (wherever formed) if they are not redeemable on demand. Annual financial statements for all other investment funds must be prepared in accordance with National Instrument 81-106 *Investment Fund Continuous Disclosure (the Continuous Disclosure Rule)* and be audited. Such statements must be made available to each securityholder of the fund and filed with the relevant securities regulators within 90 days of the year-end of the fund (however, non-reporting issuers subject to the Continuous Disclosure Rule can exempt themselves from delivering their statements to the regulators by simply notifying the regulators and placing a note in their financial statements). Semi-annual unaudited financial statements must also be prepared, filed (unless exempted) and made available to investors within 60 days of the end of the interim period. Investors may elect whether or not to receive financial statements, and the Continuous Disclosure Rule governs how instructions in this regard are to be obtained from investors. Investment funds that are reporting issuers have additional reporting and filing requirements, including delivery of an Annual Information Form and a Management Report of Fund Performance, quarterly portfolio disclosure, Material Change Reports (if applicable), change of auditor disclosure (if applicable), reporting relating to the independent review committee, net asset value and management expense ratio calculation requirements and reporting on proxy voting.
- Trade reports and fees. Investment funds offered in the exempt market are obligated to report most sales of units of the fund in a form prescribed by the securities regulator and to file such form either within 10 days of the date of sale, or within 30 days of the financial year-end of the fund, depending on the exemption relied on. There are current regulatory proposals to change this annual reporting requirement to a quarterly reporting requirement. In most provinces, upon filing the form, a fee is also payable, which is either a fixed fee or a fee based on a percentage of the subscription proceeds collected in the applicable jurisdiction. In Ontario, the fee is fixed at $500 per form filed.

by Lynn M. McGrade and Sarah K. Gardiner, Borden Ladner Gervais LLP

- General securities law reporting and compliance. Hedge fund managers must inform themselves of general securities laws and reporting requirements in Canada, including the filing of: early warning reporting reports (which generally kick in when the aggregate number of shares of a reporting issuer held or controlled by a portfolio manager, including those shares that the portfolio manager has a right or obligation to acquire within 60 days, exceeds 10% of the public float, however this threshold may be reduced to 5% if a formal takeover bid is in process); insider reports (which must be filed by any shareholder holding more than 10% of the shares of a reporting issuer); formal take-over bid circulars and related filings (once a purchaser of securities, together with all those with whom the purchaser is 'acting jointly or in concert', holds more than 20% of any class of equity or voting securities following such purchase, formal take-over bid rules apply unless an exemption is available); and advance warnings of sales from a control block, which may be required once the shareholder exceeds the 20% threshold. Legal counsel should always be contacted in this regard, as the rules differ as to which securities must be counted and how percentage holdings are to be calculated for each purpose. Fund managers must also be cognizant of insider trading prohibitions (and in particular anti-front running rules) and the prohibitions, restrictions and/or reporting obligations when there is a potential conflict of interest between the manager and the fund.

Dealing with the Public — Delivery of Disclosure Documents and due Diligence Obligations of Hedge Fund Managers

Available exemptions from the prospectus requirements

National Instrument 45-106 *Prospectus and Registration Exemptions*, together with related forms and a companion policy, (the National Exemption Rule) is an exempt distribution regime that permits distributions of an issuer's (including an investment fund's) securities to occur in any province/territory of Canada without a prospectus. The most common exemptions relied on by investment funds are:

- The 'accredited investor exemption', which permits sales to be made to government agencies, institutional investors (such as pension plans, banks and insurance companies), corporations with net assets of at least $5 million, managed accounts (except in Ontario) and other specified sophisticated investors. It also permits sales to be made to high net worth individuals which include individuals who have: a) net assets, alone or with a spouse, of at least $5 million; b) net investment assets, alone or with a spouse, of at least $1 million; or c) personal income of at least $200,000, or combined spousal income of at least $300,000, in the previous two years with reasonable prospects of same in the current year.
- The 'minimum purchase exemption', which permits sales of any one class of securities of an issuer to be made to an investor provided the aggregate purchase price is at least CDN$150,000 (a 'top-up exemption' is also subsequently available provided the investor continues to hold securities of that class that have an initial purchase price or a current net asset value of not less than CDN$150,000). There are current regulatory proposals to restrict this exemption to non-individual investors.
- The 'investment fund reinvestment exemption', which permits the automatic reinvestment of distributions by an investment fund in additional units of the same class or series.

by Lynn M. McGrade and Sarah K. Gardiner, Borden Ladner Gervais LLP

- The 'offering memorandum exemption', which may be relied on by investment funds in certain provinces (but, notably, not Ontario), that sell their securities pursuant to an offering memorandum that complies with the specified disclosure requirements of the National Exemption Rule. There are restrictions that may apply (and that vary from province to province), including limits on the amount any one investor may invest under this exemption, for example.

The National Exemption Rule does not limit the number of investors to whom securities of the fund may be sold under any of the above exemptions.

Obligations of the issuer

It is the obligation of the hedge fund to determine if a prospectus exemption is available in respect of each purchaser of fund securities. This is generally achieved by including representations and warranties of the purchaser in the subscription document. In the case of the 'accredited investor exemption', there should be a separate certificate or statutory declaration executed by the purchaser that states that he or she is an accredited investor and requiring the purchaser to identify the specific criteria met for accredited investor status prescribed in the National Exemption Rule. There should also be nothing in the investor's file with the hedge fund manager to suggest an investor does not meet the test for accredited investor status.

Delivery of an offering memorandum

If the hedge fund is relying on one of the above noted exemptions (other than the 'offering memorandum exemption') for the sale of hedge fund securities to a purchaser, there is no statutory requirement to deliver an offering memorandum. The definition of 'offering memorandum' is very broad and may include marketing materials. If any details of the offering are provided in writing, other than a basic term sheet, then the hedge fund is obligated to comply with certain provisions (under local provincial/territorial rules) that apply to the delivery of an offering memorandum to prospective investors. There are generally no specific requirements as to content for an offering memorandum (except under the 'offering memorandum exemption'), however, if an offering memorandum is delivered to investors, it may have to contain a description of the statutory rights of action that are available in some provinces to a purchaser if the document contains a misrepresentation.

If certain exemptions (such as the 'offering memorandum exemption', or the 'minimum purchase exemption' in Alberta) are relied on, a certificate is required to be attached to the offering memorandum in prescribed form. The certificate must be signed by: (i) the CEO and CFO of the manager of the hedge fund; (ii) the trustee (if applicable, or general partner or directors) on behalf of the hedge fund; and (iii) the promoter of the hedge fund. Because of the personal liability that attaches to individuals signing the certificate, consideration should be given to whether those exemptions will be relied on.

If a sale of securities is made pursuant to an offering memorandum, then a copy of that offering memorandum and any amendment thereto must be delivered to the securities commission in certain provinces if a trade is made in those provinces. Typically, the offering memorandum must be filed within 10 days of the first trade made pursuant to that offering memorandum, however an offering memorandum that is delivered to a purchaser in Quebec, for example, must be filed with the securities regulator 'without delay'.

by Lynn M. McGrade and Sarah K. Gardiner, Borden Ladner Gervais LLP

Marketing

There are no published rules regarding marketing practices in the exempt market in Canada; however a registered firm is required to 'deal fairly, honestly and in good faith with its clients'. Misleading marketing is repeatedly cited as a deficiency by staff of the Ontario Securities Commission and they have offered guidance for suggested best practices. Performance data must be clear (eg. described as net or gross of fees), material differences between fund returns and benchmark returns must be disclosed (compounded versus simple returns, use of leverage or short positions, and concentrated versus broad portfolio holdings are all relevant) and claims must not be exaggerated.

Dealer registration

In all provinces, the person acting as dealer by selling the securities that are distributed pursuant to the prospectus exemptions described above must be registered as a dealer. A category of dealer — exempt market dealer — is available for this purpose, for which there are more limited requirements than a full investment dealer or mutual fund dealer. Accordingly, hedge fund securities generally must be sold through registered dealers or by employees or officers of the fund (if there are any) who are registered as dealing representatives. The National Registration Rule governs exempt market dealers, and other categories of registration, and is discussed in further detail elsewhere in this publication.

Soft dollar arrangements and referral arrangements

All soft dollar arrangements entered into by a hedge fund manager must comply with National Instrument 23-102 *Use of Client Brokerage Commissions* (NI 23-102). Disclosure of such arrangements must be given at the time of opening a client account (fund managers may wish to include disclosure in the fund's offering memorandum) or entering into a managed account agreement, and thereafter updates must be given annually containing the information required by NI 23-102.

In addition, all referral arrangements entered into by a hedge fund manager must comply with NI 31-103. There must be a written agreement between the payor and the payee of a referral fee, and investors or other clients that are the subject of the referral arrangement must be advised of the arrangement, all in accordance with NI 31-103.

Conflicts of Interest and Self-Dealing

In general, securities legislation in each of the jurisdictions contains conflict of interest provisions that apply to investment funds in that jurisdiction. The conflict of interest provisions generally apply only in part to investment funds that are non-reporting issuers. For example, investment funds in Ontario that are mutual funds (ie, redeemable on demand), whether or not reporting issuers, are prohibited from:

- making an investment by way of a loan to any officer or director of the investment fund, its manager or its distributor or any associate of them or to any individual, where the individual or an associate of the individual is a substantial securityholder (holds 20% or more of the outstanding voting securities) of the fund, the manager or the distributor; or

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- making or holding an investment in:
  - any person or company who is a substantial securityholder of the fund, the manager or the distributor;
  - any person or company in which the fund, alone or together with one or more related funds, is a substantial securityholder; or
  - an issuer in which any officer or director of the fund, the manager or the distributor or an associate of any of them, or any person or company who is a substantial securityholder of the fund, its manager or distributor has a significant interest (a 10% equity interest).

In addition, the conflicts of interest and self-dealing provisions in the National Registration Rule prohibit certain trades by a portfolio manager on behalf of a fund, if such trades are made to or from a 'responsible person'. A 'responsible person' generally includes a portfolio manager, its affiliate and any officer, director or partner of either of them.

The rules described above are of particular importance when a manager is considering a fund of hedge funds structure. Relief from some or all of these provisions may have to be applied for, but is typically granted by securities regulators so long as they are satisfied that certain conditions are met, including that there will be no duplication of fees (or all direct and indirect fees are fully disclosed) and that certain disclosure regarding the arrangement and relationships is included in any offering document.

Other Compliance Matters for Registrants

There are many compliance obligations that apply to a hedge fund manager as a result of its role as an investment fund manager and portfolio manager. Generally, these compliance obligations are set out in an internal compliance manual for the hedge fund manager. Included in this compliance manual will be certain policies and procedures that relate to derivatives, proxy voting of securities held by the fund, conflicts of interest (including as described above), personal trading and related-party transactions, all of which may from time to time apply to the management and investment management obligations of the hedge fund manager.

The securities regulators from time to time publish reports of the results of their compliance audits of registrants. Hedge fund managers operating in Canada should read these reports carefully. The Ontario Securities Commission's Compliance and Registrant Regulation Branch publishes annual reports as well as special reports on their 'sweeps'. The annual reports summarize the common deficiencies that Commission staff encounter in their detailed compliance audits of registrant firms and provide guidance on suggested practices to address those deficiencies. 'Sweeps' are compliance audits that target a wider sampling of firms and provide somewhat more detailed guidance as to the regulators' expectations.

In addition to ensuring compliance with specific statutory and regulatory provisions, Commission staff have taken a principles-based approach to compliance, emphasizing registrants' duties to 'establish, maintain and apply policies and procedures that establish a system of controls and supervision sufficient to: a) provide reasonable assurance that the firm and each individual acting on its behalf complies with securities legislation; and b) manage the risks associated with its business in accordance with prudent business practices'. Prudent business practice can be determined both by common industry practice and by proscriptive requirements of the regulators. In this regard, hedge fund managers operating in Canada should be cognizant of conduct rules applicable to retail funds (referred

by Lynn M. McGrade and Sarah K. Gardiner, Borden Ladner Gervais LLP

to as the '81 Series' of rules), to similar rules in other jurisdictions (especially the US and the UK) and to best practices published by industry organizations and governmental committees. (Examples of the latter include the 2009 edition of the MFA's publication 'Sound Practices for Hedge Fund Managers' out of the US, the January 2009 publication 'Best Practices for the Hedge Fund Industry — Report of the Asset Managers' Committee to the President's Working Group on Financial Markets' out of the US; the January 2008 publication 'Hedge Fund Standards: Final Report' out of the UK; and AIMA Canada's series of best practices publications.) Also, the CSA have been very active in recent years in amending and creating new rules and regulations that apply to the investment fund industry as a whole, and Commission staff have a tendency, in the course of their compliance audits, to jump the gun somewhat by applying rules that have yet to come into force.

Understanding Privacy Legislation and how it applies to Hedge Funds and Their Managers

In Canada, the federal Personal Information Protection and Electronic Documents Act (PIPEDA) governs the collection, use and disclosure of personal information by private sector organizations such as hedge fund managers in the course of commercial activities, except in those provinces that have passed substantially similar legislation (currently, British Columbia, Alberta and Quebec). PIPEDA also applies to the cross-border transfer or transmission of personal information. PIPEDA does not apply to employee personal information, except in limited circumstances.

The Canadian securities regulatory authorities are generally subject to the applicable province's public sector privacy laws. Most of these provincial public sector privacy laws impose a requirement to give notice of specified information when collecting personal information. A hedge fund may be required to comply with these notice provisions where they indirectly collect personal information for a Canadian securities regulatory authority in the Form 45-106F1 discussed above under 'Reporting requirements for hedge funds'.

More generally, hedge fund managers are required to provide notice of the purposes for which they will use and disclose personal information they collect and of the recipients of the information (this may include a service provider preparing client relationship materials or mailing annual reports). Hedge fund managers are also generally required to obtain consent (express or in certain circumstances, implied), to the direct or indirect collection, as well as the use and disclosure, of personal information. Such consent may be withdrawn at any time and individuals should be advised of the consequences. PIPEDA and the provincial private sector privacy laws establish requirements in connection with the maintenance of personal information and the provision of access to an individual's own personal information. The subscription agreement used by a hedge fund may be tailored to meet the consent and other requirements established under privacy legislation in Canada.

How the Anti-Terrorist and Anti-Money Laundering Laws apply to Hedge Funds and Their Managers

In Canada, hedge fund managers, if they are registered as investment fund managers, advisers or dealers with the applicable securities regulators (as is generally required), will be subject to federal anti-terrorist and anti-money laundering laws and regulations. Such hedge fund managers are considered 'securities dealers' for the purpose of such laws, which define a 'securities dealer' as any person engaged in the business of dealing in securities, including portfolio management and investment counselling. It also includes retail distributors and fund managers.

by Lynn M. McGrade and Sarah K. Gardiner, Borden Ladner Gervais LLP

As a result, hedge fund managers must comply with the obligations under such laws to report suspicious transactions (guidelines for determination of 'suspicious transactions' are set out by the Financial Transactions and Reports Analysis Centre of Canada (FINTRAC)) and transactions that may be related to terrorist activities. As well, hedge fund managers must comply with the record-keeping and reporting requirements relating to large transactions and implement policies for the collection of information regarding the identity of investors. Information necessary to comply with such laws can be collected in the hedge fund's subscription agreement.

Registered firms (as well as exempt international dealers and exempt international advisers) must make monthly filings with their principal Canadian securities regulator respecting terrorist financing and confirming that their investors do not include 'designated persons' (or providing specific disclosure if they do).

If you are a Commodity Pool

In Canada, there is currently a national instrument (the Commodity Pool Rule), that applies to the creation and distribution of commodity pools offered by prospectus. A commodity pool is an investment fund that invests in specified derivatives or physical commodities in a manner that generally is not permitted by the rules governing prospectus-offered mutual funds. Such commodity pools are, however, subject to certain other rules applicable to retail mutual funds, and hedge fund managers in the managed futures arena must be cognizant of all such rules.

Conclusion

As you may have noted from this chapter, there are many issues to consider prior to establishing a hedge fund in Canada. Unfortunately, ongoing compliance tends to be dealt with after the fact. Dealing with these issues at the outset of the project will save the hedge fund manager time and money. We recommend that a hedge fund manager planning to establish a hedge fund in Canada meet with legal counsel to discuss the proposed structure well in advance of the intended launch date of the fund. It is ideal for the hedge fund manager, when meeting with his or her lawyer for the first time, to come prepared to discuss the nature of the investment objectives of the fund, the market that the manager would like to sell to, and the jurisdictions in which the manager anticipates initially selling the product.

Lynn M. McGrade
Partner
Borden Ladner Gervais LLP
lmcgrade@blg.com
Tel: 416.367.6115

Sarah K. Gardiner
Partner
Borden Ladner Gervais LLP
sgardiner@blg.com
Tel: 416.367.6221

Chapter 5

Managing Risk

How to Start and Grow a Successful Hedge Fund in Canada

by Scott McEvoy, Partner, Borden Ladner Gervais LLP and Supriya Kapoor, CPA, West Face Capital

Introduction

Historically, hedge funds were designed to manage or limit investment risk. For example, the earliest hedge funds, generally credited to Alfred Winslow Jones in the 1950s, combined taking long positions in undervalued stocks and short selling overvalued stocks to 'hedge' or manage the exposure that movements in the equity markets presented to their equity investments. In the case of Jones, to magnify his returns, he added leverage, using the proceeds from his short sales to finance the purchase of additional long positions to limit his exposure to risk. In this chapter, we deal with managing other risks: risks that might be posed to the hedge fund or its management as a result of the hedge fund's activities or the activities of its manager or other entities associated with the implementation of a hedge fund's investment strategy. We propose to describe the general risks associated with the fund's mandate or strategy, governance, contractual obligations and operation. Compliance with statutory requirements is dealt with elsewhere in this guide or publication.

General Risk

Mandates and strategy

Fundamental to every hedge fund is its investment mandate and the financial strategy associated with achieving it. Because the strategies are so essential and can be complex, they are often described in some detail in a hedge fund's disclosure documents and marketing materials. A clear description using plain language and explaining concepts in a way that can be readily understood by investors will reduce misunderstanding and act to minimize potential exposure. Further, the manager should describe the strategy consistently in any document that references the fund including disclosure documents and marketing materials.

In fund-of-fund arrangements (particularly one-to-one relationships) disclosure documents of the top fund must accurately describe material aspects of the bottom fund. For example disclosure of the bottom fund's investment objectives in the top fund's investment objectives may be appropriate.

Interests in hedge funds may be offered by way of distribution under a prospectus or by private placement (generally pursuant to an offering memorandum) depending on the nature of the fund and the target client market.

Prospectus

The prospectus must contain 'full, true and plain disclosure of all material facts relating to the securities' offered by the prospectus and may not contain 'an untrue statement of a material fact nor omit to state a material fact that is required to be stated or that is necessary to make a statement not misleading in the light of the circumstances in which it was made'. The term 'material fact' means a fact that would reasonably be expected to have a significant effect on the market price or value of the securities being offered.

i. ***Penal liability:*** In Ontario, if the prospectus contains a statement that in a material respect and at the time and in the light of the circumstances under which it is made, is misleading or untrue or does not state a fact that is required to be stated or that is necessary to make the statement not misleading, the person or company who made such a statement is guilty of an offence and on conviction is liable to a fine of not more than $5 million or to imprisonment for a term of not more than five years less a day, or to both. In Ontario, every director or officer of a company or of a person other than an individual who authorized, permitted or acquiesced in the making of the statement is guilty of an offence and is liable on conviction to a fine of not more than $5 million or to imprisonment for a term of not more than five years less a day, or to both.

by Scott McEvoy, Partner, Borden Ladner Gervais LLP and Supriya Kapoor, CPA, West Face Capital

ii. ***Statutory civil liability:*** In Ontario, if the prospectus together with any amendment to it contains a 'misrepresentation', a purchaser who purchases a security offered by the prospectus during the period of distribution or during distribution to the public has, without regard to whether the purchaser relied on the misrepresentation, remedies against certain parties, including the hedge fund and each person who signed the prospectus or amendment to the prospectus.

'Misrepresentation' is defined in the Securities Act (Ontario) to mean an untrue statement of material fact, or an omission to state a material fact that is required to be stated or that is necessary to make a statement not misleading in the light of the circumstances in which it was made. The term 'misrepresentation', therefore, covers not only errors and incorrect statements, but also omissions. A misrepresentation of 'forward-looking information' can also give rise to civil liability, unless certain disclaimers accompany the forward-looking information. The meaning of misrepresentation is consistent with the basic requirement that the prospectus shall provide 'full, true and plain disclosure of all material facts' about the fund and its securities. A purchaser may succeed in an action for rescission (unwinding the purchase) or damages (cash compensation) if he proves the existence of a misrepresentation at the time of the purchase of securities.

The purchaser need not prove that he was misled or that he relied upon the misrepresentation in making his purchase. In addition to any other right a purchaser may have at law, a purchaser has the following remedies:

- damages for any loss suffered against the hedge fund or a selling securityholder or, rescission where the purchaser purchased the security from such person or company;
- either damages for any loss suffered or rescission of the purchase against the underwriters of the offering;
- damages against every director of the hedge fund at the time the prospectus or the amendment to the prospectus was filed;
- damages against every person or company whose consent to disclosure of information in the prospectus has been filed pursuant to securities legislation, but only with respect to reports, opinions or statements that have been made by them; and
- damages against each person or company who signed the prospectus (if the fund is a corporation certain limitations apply to its directors).

All or any one or more of the possible defendants against whom a purchaser may exercise the foregoing remedies, including the hedge fund and each person who signed the prospectus, are jointly and separately liable for the full amount of damages awarded to a purchaser.

If a prospectus contains a misrepresentation, there are certain defences to an action brought by a purchaser of securities offered by the prospectus, including that no person is liable if they prove that the purchaser purchased the securities with knowledge of the misrepresentation.

Certain other defences are available to persons other than the issuer or a selling securityholder. However, the best way to avoid liability is to ensure that the disclosure is accurate. To the extent that the prospectus does not contain an accurate description of the strategy at the time of the purchase, there may be liability for the fund or those persons who sign the prospectus.

by Scott McEvoy, Partner, Borden Ladner Gervais LLP and Supriya Kapoor, CPA, West Face Capital

Offering memorandum

In some provinces, if a hedge fund is sold under an offering memorandum which contains a misrepresentation, the purchaser has a right of action for damages against the fund if the misrepresentation existed at the time of purchase. In some of those provinces, reliance on the misrepresentation may be required. Again, liability does not attach if it is proved that the purchaser purchased the securities with knowledge of the misrepresentation.

In Ontario and certain other jurisdictions, statutory rights accorded to the investor must be disclosed in the offering memorandum in specified circumstances (see Chapter Four, Keeping Current with your Compliance Obligations).

For the sake of consistency, where an offering is made in more than one jurisdiction, the rights of investors in other jurisdictions may be contractually stated, although they may not be legally required.

Common law liability

A hedge fund offered either under a prospectus or offering memorandum and those making statements about the hedge fund, may be exposed to liability on the basis of negligent misstatements. The law with respect to negligent misstatement is well defined and requires a misrepresentation and reliance thereon to the detriment of the investor. The misstatement may be contained in the prospectus, offering memorandum or other materials such as marketing materials.

The remedy for negligent misstatement is damages. An action may lie in negligent misstatement whether or not an investor is successful in a statutory civil action.

Example

It might be useful to provide a hypothetical example of the sort of issue that might arise in connection with an offering of hedge fund securities. A prospectus or offering memorandum might state that as a result of the strategy the net asset value (NAV) of the hedge fund would not reduce more than a specified percentage over the course of a given period of time.

Subsequently, market conditions were such that the NAV of the hedge fund did reduce more than the specified amount in the specified period of time. In fact, the manager of the hedge fund may have understood that the strategy was based on certain assumptions which, if they were not true, would result in the limit on expected loss not being true. However, unless those assumptions are clearly explained and stated, the fund might be exposed to claims for damages as a result of the description of the strategy.

Maintenance

One point that may be emphasized from the foregoing discussion is the importance of adhering to the stated strategy. If the strategy or an aspect of the strategy is material, it should not be changed unless proper disclosure pursuant to securities legislation is made to investors. Therefore, while market conditions may indicate that a departure from the disclosed strategy would be advantageous, it should not be changed without appropriate disclosure if such a change would be a 'material change' within the meaning of securities legislation. The constating document for the fund (eg, trust agreement or limited partnership agreement) may stipulate when existing investors must approve a material change or otherwise have a right to receive notice of a change in the strategy.

by Scott McEvoy, Partner, Borden Ladner Gervais LLP and Supriya Kapoor, CPA, West Face Capital

Best interest standard

It is worth noting that in Ontario a best interest standard is applied to investment fund managers in their dealings with the investment funds they manage. The Ontario Securities Commission has indicated that under this standard of care investment fund managers should ensure that all information contained in the offering memorandum of an investment fund managed by them is factual, accurate and not misleading. The OSC has also emphasized that investment fund managers should review the offering memoranda of their investment funds to ensure that they adequately and accurately disclose all material facts relating to the investment funds, including: (i) the types of expenses that are to be paid by the funds in clear and specific terms; (ii) conflict of interest matters, such as fees paid to related parties; and (iii) details on how any performance fees are calculated, including how any hurdle rate is to be applied if the fund's performance exceeds any high water mark part way through the year.

There is no equivalent provision in Ontario that explicitly applies a best interest standard to dealers and advisors in their dealings with their clients (but there is a requirement to deal fairly, honestly and in good faith with their clients). Canadian regulators are reviewing the application of a common statutory best interest standard for registrants. Participants in the hedge fund industry should be aware of this development in the coming years.

Governance risk

Capacity

Each hedge fund, regardless of the chosen structure, is established by statute or constating documents, or some combination of the two. In either case, the capacity of the fund and the authority of those taking action on behalf of the fund flow from those documents. To manage compliance risks, it is important to draft the documents in the first instance so that they accurately describe the proposed actions to be undertaken by the fund. If, as part of its strategies, the fund intends to undertake derivative transactions, post margin, enter into short or long sales strategies, buy futures or commodities and take various other actions, the documents must ensure that it has the power to do so. If there is no power to undertake the transaction, the transaction may be found void, leading to potential losses by the fund and its investors.

It is also good practice to check the constating documents of the hedge fund from time to time, to ensure that they contain authority for the actions currently being undertaken by the fund and also that references are current and up-to-date.

Chain of authority

In addition to ensuring that the fund has the capacity to act, there must also be an unbroken chain of authority to the persons or entities who undertake the activity on behalf of the hedge fund. For example, if the hedge fund is structured as a trust, the trust document must contain a mechanism to permit the conduct of an activity by the person or entity intended to conduct it. If the trustee is to undertake the activity, no further documentation may be required. Alternatively, the trust document may stipulate that a manager or settlor or other party to the document reserves the power to undertake certain activities related to the management of the hedge fund. Again, no further documentation may be required.

Finally, the trust document may permit delegation by the trustee or other party of the power to perform certain activities to others.

by Scott McEvoy, Partner, Borden Ladner Gervais LLP and Supriya Kapoor, CPA, West Face Capital

Whatever method is chosen, the chain of authority to the person conducting the activity must be clear and must be sufficiently broad to allow it to conduct the activities. The chain of authority may go through several steps, depending on how the activities are conducted. For example, the authority may start in a trust document under which a manager reserves the power to manage investments. The manager may have the power to appoint others to carry out derivative transactions in certain markets. The appointment and the full scope of the power must be reflected in the agreement between the manager and such other person. That other person may have a further power to delegate various portions of the activity.

There may also be certain checks that must be incorporated into the chain that are required under securities laws. For example, hedge funds that are offered publicly and that are required to have an independent review committee (IRC) under NI 81-107 must ensure that documentation reflects the role of the IRC – to consider and provide recommendations or approvals about the fund manager's management of conflicts of interest.

In each case, the documents must specifically set forth: (i) the power to appoint others, if required; and (ii) the power to undertake the activities contemplated. Documents must be carefully drafted to include the appropriate powers and should be reviewed from time to time to ensure that the actions are still within the authority set forth in the documents.

To minimize exposure for the actions of other persons in the chain of authority, the agreement should contain an indemnity in favour of the entity granting the power equal in scope to the liability of that entity under the documents which gave it the power. In other words, the chain of authority must be accompanied by the chain of indemnity or liability of equal scope.

Consents, approvals and filings

The documents under which the activities of a hedge fund are undertaken may require certain consents or approvals to be obtained before actions are undertaken. Further, certain actions may require the approval or consent of regulators, investors and in the case of public hedge funds, their IRCs. Managing governance risk requires obtaining the appropriate approvals, in writing if necessary, and retaining records of those approvals or consents.

Hedge funds structured as limited partnerships and as trusts are required to make certain regulatory filings in most cases.

For example, there may be filings under the applicable limited partnerships legislation or of financial disclosure under applicable securities A hedge fund may be a party to various contracts in conducting its operations, which may include the following:

- derivative contracts;
- loan agreements;
- margin agreements;
- brokerage agreements;
- prime brokerage agreements;
- purchase and sale agreements;

- securities lending, repurchase and reverse repurchase agreements;
- custody agreements;
- depository agreements; and
- advisory or sub-advisory contracts

Each contract will impose obligations on the hedge fund and, typically, its manager. Part of managing the risk associated with a hedge fund is to ensure that it discharges its contractual obligations appropriately. Contracts may specify leverage limits, notice requirements, prior consents, approvals or conditions for various actions, report requirements and time limitation, as well as various other actions. Effective management requires knowledge of all contractual requirements and monitoring of compliance with them.

It is good practice for a hedge fund in its contracts to limit recourse to the assets of the fund itself, whether the fund is a limited partnership, trust or other structure. The objective of limiting recourse is to protect the interests and assets of the investors in the fund. There is statutory protection for shareholders of corporations and for limited partners of limited partnerships (though in the case of a limited partnership this limitation of liability protection is lost if the limited partner takes part in the control of the business). In the event that the hedge fund is structured as a trust, certain jurisdictions have legislation which limits the exposure of the beneficiaries of the trust (the investors) to their investment in the fund so that they are not liable for liabilities of the fund in most instances, but only if such trusts are offered by prospectus.

Operational risk

Supervisory relationships

Delineation of the duties among those providing services/functions to a hedge fund will be important to the success of the fund. Documentation of these roles and duties among auditors, prime broker, administrator, fund manager and legal counsel will ensure that nothing is overlooked. Similarly, without proper documentation of roles it becomes more difficult to monitor the activities of service providers where all, or a portion of investment advisory, management or other duty has been delegated

National Instrument 31-103 Registration Requirements, Exemptions and Ongoing Registrant Obligations (NI 31-103) requires investment fund managers to establish a system of controls and supervision to ensure compliance with securities legislation and to manage their business risks in accordance with prudent business practices. The Companion Policy to NI 31-103 states that registrants that outsource aspects of their business operations to third-party service providers are responsible and accountable for all functions that have been outsourced. In order to meet these obligations a fund manager must oversee its service providers including review of their work and documenting monitoring arrangements.

However, the simple execution of a contract stipulating the terms and conditions upon which a sub-advisor, for example, is expected to perform its duties to the manager or other administrator does not remove the regulatory obligations and fiduciary duties of the manager to its clients and the exposure of the manager for failure to discharge them.

by Scott McEvoy, Partner, Borden Ladner Gervais LLP and Supriya Kapoor, CPA, West Face Capital

In the case of an investment fund manager that also acts as portfolio manager supervising a sub-advisor, the trading activities of the sub-advisor must be monitored for adherence to the objectives and strategies of the fund, as well as applicable securities legislation. Adequate monitoring, in turn, requires that policies and procedures are in place to receive and evaluate information from such sub-advisor. Procedures should include:

- performance of due diligence prior to the selection of a sub-advisor; due diligence might include such things as assessing the internal policies of the sub-advisor covering such matters as best execution and soft dollar arrangements, personal trading, allocation of investment opportunities, cross trading, money laundering, and anti-terrorist reporting;
- requiring certification by senior officers of the sub-advisor confirming adherence to policies and procedures;
- periodic comparison of the securities held in the fund's trading account against fund objectives and strategies; and
- periodic testing and variance analysis of the fund's portfolios to ensure proper valuation.

In certain circumstances, securities regulation requires advisors to retain primary responsibility to the fund and its investors in the event of a failure by a sub-advisor to adhere to the investment objectives and strategies of the fund.

Sales/manager activities

i. ***Registration:*** Canadian securities laws generally require registration as a dealer for any person or company that is in the business of trading in securities. The definition of 'trading' is extremely broad and includes 'any act, advertisement, solicitation, conduct or negotiation directly or indirectly in furtherance of' a trade. The question of whether entities satisfy the 'business trigger' will generally be fact-specific and may not apply to all entities engaged in similar activities. However, any activity involved in marketing or promoting sales of securities of a hedge fund could be considered an act in furtherance of a trade in securities. NI 31-103 extended the 'limited market dealer' category across Canada as 'exempt market dealer' such that entities participating in exempt trades will likely require registration. Similarly, NI 31-103 introduced the category of 'investment fund manager' for those entities that 'direct the business, operations or affairs of an investment fund' (see Chapter Three, Registration in Canada).

ii. ***Suitability:*** In Canada, hedge funds are typically marketed through investment dealers, mutual fund dealers or exempt market dealers, each of which have a suitability obligation requiring the registrant to take reasonable steps to ensure that, before it makes a recommendation to, or accepts an instruction from, a client to buy or sell a security or makes a purchase or sale of a security for a client's managed account (in the case of a portfolio manager), the purchase or sale is suitable for the client. Among other things this requires a dealer to collect and maintain current know your client information. Such information should allow the dealer to ascertain the general investment needs of its clients, as well as the suitability of a proposed transaction. Prospective investors should be asked questions such as:

   a. What are their investment needs and objectives and financial circumstances?

   b. Does the investor have any investment restrictions?

by Scott McEvoy, Partner, Borden Ladner Gervais LLP and Supriya Kapoor, CPA, West Face Capital

c. What is the investor's risk profile/ tolerance for risk?

d. What is the investment time frame of the investor and what are his or her expectations in terms of return?

e. What are the expectations of the investor in terms of transparency?

f. What is the investor's true financial strength?

iii. ***Due diligence:*** The manager should perform due diligence on prospective investors in the fund. Failing to do so will lead not only to a lack of understanding of the client's investment needs, but could also lead to operational problems in difficult markets. Uneasy investors who do not fully understand the product and its strategy may redeem too early, jeopardizing their own investment as well as the fund's portfolio.

This due diligence process means engaging in meaningful discussions with investors including meeting with investors face to face and asking detailed questions to assist in understanding the client's needs and objectives. If it is not possible to meet with a client face to face, a registrant should carefully document the additional steps taken to demonstrate compliance with know your client and suitability obligations.

The fund must set some transparency expectations. Risks of strategies must be clearly articulated to investors and there must be a regular communication of the risks to investors in order to provide them with a high degree of comfort and reduce future problems.

Most due diligence efforts are built upon the investor's self report of his or her income/net worth status. As economic trends place more individuals in the accredited investor category, the sufficiency of this approach may be challenged. Clearly it is no longer satisfactory to engage in a 'tick the box exercise', however, prospective investors may be reluctant to reveal detailed personal financial information. Consideration should be given as to how to deal with this if the investor does not give the information.

If money is received from a prospective investor before it has been determined whether the investor is qualified to purchase securities of the fund, these monies must be received into a separate account rather than directly into the trading account of the fund.

Marketing materials

1. ***General:*** Growth in the hedge fund industry has, in part, been attributable to the ability of hedge fund managers to adjust strategies to market conditions. Hedge funds often have broadly drafted disclosure in offering documents. The broad nature of this disclosure has the advantage of permitting hedge funds to respond in a flexible fashion to market conditions. This flexibility, in turn, enables hedge funds to perform well in down markets. The disadvantage of broad disclosure is the risk that investors will not be provided with a sound basis for evaluating whether to invest in the fund, and it may not adequately disclose specific risks inherent in a strategy. Finally, any document that is provided to a prospective investor should address conflicts of interest. A conflict of interest is any circumstance where the interests of different parties are inconsistent or divergent. Registrants are required to take reasonable steps to identify existing material conflicts of interest, and material conflicts that the firm reasonably expects to arise between the firm and a client. Disclosure of these conflicts must be made to a client if a reasonable investor would expect to be informed of the conflict.

by Scott McEvoy, Partner, Borden Ladner Gervais LLP and Supriya Kapoor, CPA, West Face Capital

2. ***Offering documents:*** For a hedge fund offered pursuant to the accredited investor prospectus exemption there are few requirements in relation to the form of the offering document. Often an offering memorandum will be used as a marketing and information document for prospective investors that describes the business and affairs of the issuer.

   As well as providing the basic terms of the offering, including objectives and strategies of the fund together with such details as the entities providing services in connection with the offering, the offering memorandum should seek to provide a fair and balanced presentation of the risks and potential disadvantages of hedge fund investing. Discussion of risks could include statements that hedge funds:

   i. engage in leveraging and other speculative investment practices that may increase the risk of investment loss; can be highly illiquid;
   ii. are not required to provide periodic pricing or valuation information to investors;
   iii. may involve complex tax structures and delays in distributing important tax information;
   iv. are not subject to the same regulatory requirements as retail mutual funds; and often charge high fees.

3. ***Use of the Internet/social media:*** A hedge fund manager should ensure consistency in its marketing activities across media. If sales of a fund are restricted to accredited investors, access to information about the fund on the Internet should also be restricted and warnings and disclosure included. The Canadian regulators have indicated that fund managers should consider the appropriateness of certain new media formats if content limitations prevent the fund manager from providing clear, accurate and balanced messages in the 'sales communication' or insert the required warning language, including a within 'one click' requirement of such warning language. Fund managers must also review their procedures for sending commercial electronic messages (CEMs) such as email and text messages. Under Canada's new anti-spam legislation (known as 'CASL') which comes into force 1 July 2014, a single email sent to a person that has a commercial purpose falls under CASL. While certain exemptions may apply including emails sent between businesses that have an existing relationship, and that relate to the activities of the business, CEMs that fall outside of an exemption are subject to consent, content and an 'unsubscribe' mechanism requirements.

Consistency in disclosure

Policies and procedures must be in place to ensure that all sales and marketing materials are consistent with the disclosure documents and constating documents of the fund. Where the manager's website is used as a marketing tool, one individual should have responsibility for control and posting on the site. This individual should ultimately report to the compliance function, ideally the chief compliance officer, to ensure consistency in communications.

Similarly, the message communicated to those selling the product (whether in-house or through a registered dealer) must be consistent with disclosure documents. Policies and procedures must be in place to ensure adequate training and supervision of those individuals involved in selling the fund. Dealers must have policies and procedures in place that require their registered individuals to demonstrate that they have satisfied their obligations to adequately explain the risk disclosure to clients.

by Scott McEvoy, Partner, Borden Ladner Gervais LLP and Supriya Kapoor, CPA, West Face Capital

Periodic reporting

Many hedge fund managers provide periodic reports to their investors, whether or not specifically required to do so under securities legislation.

As a registrant, managers must also ensure compliance with new disclosure requirements under the CSA's client relationship model (CRM). The CRM changes include detailed reporting–at specified times–to clients on an account-by-account basis of: (i) compensation received by the firm or its representatives; and (ii) performance of the investments held in the account.

Where the hedge fund is a 'reporting issuer' in a jurisdiction, it will be required to comply with the continuous disclosure regime, including the filing of financial statements and other information. Unless exemptions have been obtained (or elections made) certain of these filings (for example, annual and semi-annual financial statements) may still be required even where the hedge fund is not a reporting issuer.

In preparing periodic reports, hedge fund managers should provide adequate information on a consistent basis clearly explaining significant assumptions that have been used in preparing the information. Often, a manager will provide account statements reporting capital account balances.

Where performance information is provided, historical data should be audited. Managers should consider providing detailed information about a fund's investments. If the manager has drifted from the fund's primary investment strategies this should be explained. Relevant market commentary may also be included.

Third-party reporting

Information about a fund may be contained on websites sponsored by persons not connected to any hedge fund (a third-party website). Such sites may provide one location, listing descriptive and performance-related information about a number of funds. Sometimes this information is provided to subscribers for a fee. Hedge fund managers should ensure that the information contained in relation to the fund on these sites is accurate and complete.

Where hedge fund indices are used on these sites, hedge fund managers should ensure that the assumptions used for the creation of a composite or database are accurate.

Hedge fund managers should be cognizant that certain institutional reporting services and financial newsletters may also report information about hedge funds which contain inaccuracies. In today's heightened climate for 'stories' by the media, managers should be on their guard for any potential misreporting.

Scott McEvoy, Partner
Borden Ladner Gervais LLP
smcevoy@blg.com
Tel: 416.367.6117

Supriya Kapoor, CPA
West Face Capital
supriya.kapoor@westfacecapital.com
Te: 416.479.7330

Chapter 6

Building an Effective Governance Program for Hedge Funds

How to Start and Grow a Successful Hedge Fund in Canada

by W. William Woods, Independent Review Inc.

In the case of publicly-listed companies, there are now well-established standards of best practice and guidelines in respect of corporate governance. These standards have evolved through legislative and regulatory reforms and the initiatives of capital market participants over the last ten years. More recently, in 2013, the Office of the Superintendent of Financial Institutions has issued a revised Guideline on Governance for Federally Regulated Financial Institutions in Canada.

The corporate governance of investment funds is regulated in Canada through National Instrument 31-103 *Registration Requirements and Exemptions* and National Instrument 81-107 *Independent Review Committee for Investment Funds*.

Although NI 81-107 is only applicable to investment funds which are offered to the public, hedge funds are increasingly experiencing pressure from investors to improve governance standards, particularly when they seek investments from large institutional shareholders.

What is Fund Governance?

In the case of a company, 'corporate governance' relates to the activities of the board of directors of the company who are elected by, and are accountable to, the shareholders, and takes into account the role of management who are appointed by the board of directors and who are charged with the ongoing management of the corporation. In the case of a fund, 'fund governance' refers to the oversight role and decision-making processes of the governance body of that fund. If the fund is structured as a company, that means the board of directors and any board committees. If the fund is a unit trust, the governance body is the board of trustees and any committees of that board.

Whenever one is considering what the appropriate standards of governance are for a fund, it is important to bear in mind the perception that the regulators in Canada and throughout the world have of funds, which can best be summarized as follows: 'The national public interest and the interest of investors are adversely affected when investment companies (funds) are organized, operated and managed in the interest of others, rather than in the interest of their securityholders.'

Under Canadian regulations, when managing an investment fund the manager must:

- act honestly and in good faith, and in the best interests of the investment fund; and
- exercise the degree of care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances.

However, the manager may not be able to objectively determine whether it is acting in the best interests of the investment fund when it has a conflict of interest.

Adequate oversight and effective decision-making are therefore seen as critical, by regulators, for the protection of the fund's securityholders. NI 81-107 is designed to reinforce the manager's fiduciary duties, by imposing independent oversight in those areas where the manager may have a conflict of interest, and thus may not be objective in making decisions about the fund.

by W. William Woods, Independent Review Inc.

Hedge Funds are a Special Type of Business

Unlike operating companies, a fund business usually outsources most of its operations, including the investment management and the administration functions. Hedge funds tend to be relatively small in comparison with public mutual fund organizations and rely more heavily than other funds on outsourcing many functions to third-party service providers.

This type of 'externalized management' is not common in other industries and makes hedge funds a special type of business. This outsourcing allows a small number of principals to manage very large amounts of assets. There is now close to US$3 trillion under management in over 10,000 hedge funds worldwide. Here In Canada, *Investor Economics* research indicates there is over $30 billion in around 200 hedge funds.

In addition, hedge fund securities are now being held by a much wider range of investors, including many individuals of modest net worth, either directly or through pension funds (which are increasingly investing in hedge funds).

This growth in assets under management and the widening of the investor base has already led to an increasing regulatory focus on hedge funds, especially in Canada, where a number of hedge fund scandals have heightened concerns about how hedge funds are operated.

Hedge Fund Governance Issues

As with every investment manager, a hedge fund manager can find itself in situations where its business and commercial interests conflict with its fiduciary duty to act in the best interests of the fund. As we have seen, the regulators believe that there is potential for abuse if a fund is organized, operated and managed in the interests of the investment manager and not the securityholders.

Pursuant to NI 31-103 (Section 13.4), a registered firm must take reasonable steps to identify existing material conflicts of interest, and material conflicts of interest that the registered firm in its reasonable opinion would expect to arise, between the firm, including each individual acting on the firm's behalf, and a client. The CSA considers a conflict of interest to be any circumstance where the interests of different parties, such as the interests of a client and those of a registrant, are inconsistent or divergent.

A registered firm must respond to an existing or potential conflicts of interest by:

- avoidance;
- control; and/or
- disclosure

The Instrument states that, depending on the conflict of interest, registered firms may control the conflict by creating a group or committee to review, develop or approve the manager's responses.

All investment managers can experience two different types of conflict situations — business conflicts and related-party conflicts. Now that investment management is increasingly just a part of a full service financial business, the potential for related-party conflicts is increasing. Although hedge fund managers tend to be independent entities which have less 'related-party' conflicts there are still plenty of potential business conflicts including, *inter alia*:

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- pricing the portfolio–the manager obviously has an interest in the pricing of the securities, since fees are derived from the NAV value. There have been enough scandals involving mispricing or fraud by hedge fund managers to alert investors to this issues. Most hedge fund managers now out-source pricing to an independent fund administrator;
- inter-fund trading or purchasing or continuing to hold securities issued by an entity which is related to the manager (eg, where the manager also invests in an issuer, or owns an issuer, of securities bought by the fund);
- advising other investment funds or accounts at the same time as the hedge fund (in which case, how are expenses and costs allocated?);
- having multiple business relationships with the main service providers to the fund;
- best execution issues, including 'soft dollar' arrangements or directed brokerage; and
- deciding how to allocate trades between the hedge fund and other accounts.

The Role of the Board

The board of directors or board of trustees (in both cases the 'board') of the fund is ultimately responsible for the operation of the fund — ie, it must assume leadership and control of the fund. Fund boards have, in addition to their general oversight responsibilities, an extra duty to monitor those areas where conflicts of interest might exist. Since many hedge funds now have institutional investors (such as pension funds) and some have several hundred individual investors, the governance standards of hedge fund boards can have a significant impact on a large number of investors, even though the funds themselves may not be listed or publicly traded.

Therefore, it makes sense for the Canadian hedge fund industry to voluntarily adopt international standards of fund governance in order to avoid giving Canadian regulators an excuse to start imposing such standards on them by way of unwanted regulatory oversight.

So what are the relevant fund governance standards for Canadian hedge funds?

Due to the unique organizational structure of funds, regulators sometimes require that they have a significant number of 'independent' directors. The independent directors are responsible for monitoring carefully the relationship between the fund and the manager and any other service providers. The term 'watchdog' has been used to describe the independent directors' role.

In the US, public mutual funds have been required to have independent directors since 1940. The SEC requires that the chairman and at least 40% of the board of directors of all public mutual funds must be totally independent from the fund manager. In practice, independant directors hold an overwhelming majority (75%) of board seats in 90% of US fund complexes.

However, private hedge funds will experience pressure to adopt the same or similar standards from both existing and prospective shareholders.

Under NI 81-107, every public investment fund must set up an independent review committee (IRC). NI 81-107 states that a manager may not be able to objectively determine whether it is acting in the best interests of the mutual fund when it is in a conflict of interest situation. NI 81-107 therefore requires that any situation in which a reasonable

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person would question whether the manager has a conflict of interest must be referred by the manager to the IRC for a second review and/or approval of the recommended course of action. An IRC must comprise at least three people who are totally 'independent' of the fund and the manager.

In the case of inter-fund trades and investments in related entities — which are currently prohibited by Canadian securities regulations — the manager cannot take action without the approval of the IRC.

The IRC therefore acts as a sounding board through which the manager's proposed actions on conflict of interest matters are subjected to a sober second review.

Independent Advisory Board

In order to match these new standards, every Canadian hedge fund should consider having the equivalent of an IRC. There are some hedge funds that already have such committees, although they are generally called 'advisory boards'.

The advisory board provides independent oversight of the fund and the fund manager. Having an advisory board demonstrates to potential investors that the fund manager has considered the governance issues and has established an independent governance body for the protection of investors in the fund. In this way, the fund manager is able to act more as a service provider to the fund rather than as its controller.

Key Issues for a Fund's Board

In addition to the straight 'conflict of interest' issues, the independent directors on a fund's board, and any independent advisory board, should be involved in the following key areas:

- the appointment of third-party service providers;
- compliance issues;
- remuneration issues; and
- effective communication.

Appointment of third-party service providers

One of the prime duties of the directors of a hedge fund is to review and approve the appointment of all the third-party service providers. A hedge fund should only appoint reputable and experienced service providers appropriate for the size of the fund. The directors should ensure that all the service providers have the standing and expertise appropriate to their function for the hedge fund. The service provider's role, responsibility and any service level commitments should be clearly documented in a service agreement approved by the board. The board should also monitor the performance and fee levels of all service providers on a periodic basis against the committed level of service.

Compliance issues

As a result of a number of hedge fund scandals in Canada, NI 31-103 now requires that every hedge fund in Canada must have a designated 'chief compliance officer'. Unfortunately, the Canadian regulators do not currently allow the fund manager to outsource the CCO function to a professional firm. However, the portfolio manager can normally also be dual registered as the CCO.

by W. William Woods, Independent Review Inc.

Despite this regulatory flexibility, most institutional investors will insist that a fund has a separate CCO before they will invest. It is important that all hedge funds develop a culture of compliance from the start, getting professional help to set up the policy and procedures, then engaging a full-time CCO, as soon as they can justify the additional expense.

Remuneration issues

For public companies, management remuneration has been a major public issue in the last few years. Independent mutual fund directors generally receive a fixed annual fee or a 'per meeting' fee. Independent mutual fund director fees are increasing rapidly in the US and Canada.

In the area of manager remuneration, hedge funds can in some ways be said to be ahead of public companies, since the investment manager's primary reward is the performance fee, which is based solely on the performance of the fund. The basic management fees for hedge funds tend to be much lower than that for traditional mutual funds (1-2% rather than 3-5%).

Moreover, where the performance fee methodology includes hurdles and high water marks, the investment manager is only rewarded when the investor's holdings actually increase in value (contrast that with the so called 'fat cat' directors on public company boards whose remuneration increases even if the share price declines).

Effective communication with securityholders

Corporate governance standards now require adequate disclosure of information to investors on a consistent and timely basis. In the case of hedge funds, this means that regular performance data (and any commentary from the manager) is communicated to all securityholders as soon as possible after the net asset value is finalized following each valuation period.

The board should also seek to ensure that any material items of information or changes are disclosed to all investors affected by those items or changes (and generally not seek to differentiate communications to investors or the timing of disclosures, based on the size of the investor's investment or the nature or content of the disclosure).

Conclusion

Due to the size of investors' assets now held by hedge funds and the expansion of the investor base, the governance standards demanded of publicly-listed companies and public investment funds, with some limitations, are broadly applicable to hedge funds.

Canadian hedge funds should therefore adopt international standards and have independent directors and/or establish an independent advisory board. Voluntary compliance now will help to avert the imposition on Canadian hedge funds of more rigid governance standards in the future.

W. William Woods
President & CEO
Independent Review Inc.
wwoods@independentreviewinc.com
Tel: 416.849.1928

Chapter 7

Marketing Hedge Funds

How to Start and Grow a Successful Hedge Fund in Canada

by Julie Makepeace, Alliance Sales and Marketing

At the outset, it is important to recognize that an asset management firm has two main lines of business: raising capital and investing capital. Everything else (administration and processing, finance, research, compliance, etc.) is in support of these two critical success factors. An asset management firm needs a Chief Marketing Officer as much as it needs a Chief Investment Officer, and certainly as much as a CFO and CCO. Hedge fund managers who do not recognize the importance of the Marketing function early on, usually don't achieve their goals for inflows of new capital.

When starting a new hedge fund company, it is common for money managers to begin with their own money and that of friends and family. Many anticipate that once strong returns are posted, the money will find them and start rolling in. Perhaps it should work that way, but there is considerable evidence demonstrating that the largest fund companies, those with the strongest capital inflows, don't necessarily have the best returns or risk-adjusted returns. However, those funds do have high visibility, a sound reputation among their targeted investor group(s), and the best overall value, or perceived value, to their investors. This is achieved through effective execution of clear and intelligent marketing strategies in each element of the marketing mix.

These are challenging times in which to start and grow a hedge fund; not just in Canada. As investor and regulatory demands grow, managers are focusing relentlessly on operational efficiency and costs in the battle to maintain margins. Even managers experiencing an increase in revenue, as their performance improves and assets grow, are not necessarily gaining improvements in margins.

Despite these challenges, to be successful in raising assets in today's competitive environment it is imperative that hedge fund managers allocate resources to marketing. It is necessary to clearly identify and prioritize the target investor audiences, to focus on all aspects of the quality of the hedge fund offering to ensure investors' needs are met and to effectively articulate the message to the marketplace so that investors' perceptions of the quality of the offering are accurate.

It is not easy, in today's competitive landscape to break through the clutter of investment choices and beliefs. Prioritising and effectively allocating time, energy and money to all the important activities, including marketing, will be key to any firm's overall success.

Some firms decide not to spend time and money on marketing activities in the first year (or two or three) until a strong performance track record has been built. However, it is important for all funds to develop a comprehensive, well-thought-through, five-year strategic marketing plan at the outset, one that embraces this time-plan. Once the strategy is in place, the tactical execution (including the timing) will naturally follow.

Overview of a Five-Year Strategic Marketing Plan

Market Definition and Category Structure

Market Size and Growth Trends
Competitive Environment
- Investor Target Audiences
- Distribution
- New Products/Technology/Pricing
- Service
- Sales Force
- Advertising/Promotion Practices

Relative Market Share
Competitor Strengths/Weaknesses

Outlook

Environmental Factors (ie, Regulatory, Legislative)
Anticipated Trends

SWOT Analysis

Description of Your Investment Product Offering:
- Strengths
- Weaknesses
- Opportunities
- Threats

Long-term Goals

Assets
Market Share
Share of Key Market Segments (eg, HNW Investors, Dealers, Endowments and Foundations Pension Funds)
Profitability

continued ...

by Julie Makepeace, Alliance Sales and Marketing

Strategic Thrusts

Risks

Investment Fund/Product Line Strategies

Market Segmentation and Target Investor Audience
Branding and Positioning
Product Line-up, Features and Pricing
Distribution
Sales Force
- Segmentation and Target Audience
- Positioning
- Compensation
- Wholesaling
- Communication
- Sales Support
- Service

Communications (ie. Advertising, Promotion and Public/Media Relations)
Investor Service

Next Year Program and Key Activities (including timing and budget)

This section of the marketing plan would include the detailed tactics that will be employed to execute the strategies outlined above.

Conclusion

With solid, well thought out strategies and effective, process-driven tactical execution of these strategies, hedge fund managers set themselves up for success in raising capital and achieving their long-term goals.

Julie Makepeace
President
Alliance Sales and Marketing Inc
jmakepeace@alliancesalesandmarketing.com
Tel: 416.906.3782

Chapter 8
The Top 10 Rules Hedge Fund Managers Should Follow to Attract and Keep Great Investors

How to Start and Grow a Successful Hedge Fund in Canada

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by Jeff Banfield, JMO Research

Introduction

An important point hedge fund managers should keep in mind is that the best investors don't want to micro- manage their managers. Integrating the following points into the framework of a hedge fund will greatly improve a fund's appeal to institutional and high-net-worth investors. These points are often given equal or greater consideration to performance, as these guidelines will help to prevent problems in the future.

Rule 1: Liquidity and integrity

If your fund accepts money monthly, then it should provide liquidity monthly. Not all requests for redemption are based on unsatisfactory performance. Giving investors the opportunity adjust their exposure to a fund within a reasonable timeframe is essential for managers trying to convey the message that they are able to manage liquidity risk in the portfolio. Most funds these days have market disruption clauses that provide the manager with the option to restrict redemptions during times of severe market duress. Investors want this clause, as it helps to reduce volatility. However, for a manager to need more than 20 days to generate 10%, or even 15%, cash during properly-functioning markets is absurd. A long notice of redemption period is a huge red flag to investors. It says a large proportion of the fund's investments are illiquid and, therefore, carry an elevated level of risk. In today's world, a hedge fund manager definitely wants to avoid being labeled illiquid at all costs.

Rule 2: Information on a timely basis

Hedge funds should provide investors with timely month-end net asset value (NAV). Estimates within seven days of month-end are no longer a challenge, and are becoming an indicator of how strong a fund's internal controls are. Providing investors enough time to make informed decisions as to whether any changes to their holdings are warranted is essential to attracting good investors. Today, prime brokers provide their clients with overnight valuations that are accurate Almost all manager's know their fund's NAV (within a hundred basis points), within three days of their month-end. If a manager doesn't have this information, or isn't sure of its accuracy, the message being conveyed to the investor is either the manager's back office and accounting are not well organized, or the portfolio is too illiquid to value on a timely basis.

Rule 3: Fairness for all

In business, it is common to have penalties levied when commitments are broken. Investors agree to invest their capital based on the terms provided in the offering documents. The terms will often stipulate a minimum hold period. The same material often provides a targeted return and volatility the fund will generate. If the hold period is violated, a penalty is imposed by way of a redemption charge. This is acceptable, as long as the manager has also upheld their commitment to generate the targeted return and volatility. Simply put, from the perspective of the investor, if the funds performance is negative over a reasonable period of time (eg, six to eight months), or the fund experiences abnormal volatility swings relative to its historical relationship to general market volatility over a similar time frame, then the investor should be entitled to redeem without penalty, as the manager has failed to uphold their commitment.

by Jeff Banfield, JMO Research

Rule 4A: Alignment of interests

It doesn't get much simpler than this; an individual confident enough in their investing skills to tie their compensation to the performance of a fund should be confident enough to leave the majority of the compensation in the fund going forward. Investors have been outraged by managers who received huge amounts of money as the value of their fund went up, but lost little of that money when the same fund dropped substantially in value. If it's OK for hedge fund managers to be partners in the gains of a fund, then they must be willing to maintain that relationship during times the fund suffers losses. In order to accomplish this, managers should only be paid a portion of the performance fees annually, and the remainder paid when either an investor's capital is redeemed, or the partnership is dissolved entirely. If the manager feels that under this structure, his capital is excessively exposed to risk during the life of the fund and wishes to reduce the exposure, they can return a portion of the capital under management back to investors and receive the unpaid performance fees on that capital. Alternatively, if a manager is concerned about the level of risk their wealth is exposed to in a certain market environment, then they can move capital to cash, therefore, reducing the risk to all investors. Managers that align their interests with investors by paying out all fees but reinvesting a portion of the after-tax proceeds of their compensation in the fund are not exposed to the same level of risk, and any graduate of sixth grade math knows this. To imply otherwise is insulting to the investor.

Rule 4B: The good investors want their managers to be properly paid

Good investors don't want money management decisions influenced by the manager's need to pay bills. It is important that a manager be paid enough to meet overhead and be provided with a reasonable income. As a rough guide, performance fees on assets in excess of $50 million should be deferred as explained above. A firm that has $50 million under management and generates 16% net to investors per annum will generate $3 million in revenue a year. This is sufficient to satisfy overhead for a small firm. By deferring just the performance fees on assets above $50 million, the manager is aligning their interests with those of their investors, and providing investors with a sense of equality. As an added benefit, it allows the manager to compound their own earnings pre-tax thus increasing their wealth more quickly. The best managers will leap at the chance to do this. As a consequence of this approach, investors will have to pay tax on the deferred returns (a small price to ensure alignment of interests), which will be recouped on redemption. Resistance by a manager to accept deferred compensation is a huge red flag to excessive greed and a lack of confidence by the manager in their own skills.

Rule 5: Compare apples with apples

Comparing a fund's performance to a benchmark that has little or no bearing on the fund's returns is blatant misrepresentation, and investors see this. If a manager runs a long/short fund in resource stocks, then it should be compared with a long/short fund benchmark and a resource index, not the Morgan Stanley Global EAFE Index or the Standard and Poor's 500 Index. If you're a 500-pound gorilla, don't try to hide behind a twig. Smart investors know what kind of manager they are investing in and if your monthly reports provide bogus comparisons, investors will notice the 500-pound gorilla behind the twig.

by Jeff Banfield, JMO Research

Rule 6: Time is money

Given that a manager should know within 100 basis points the NAV within three days of month-end, it seems more than reasonable to pay out 90% of redemption proceeds on the fourth or fifth day after month-end. Following a redemption date, an investor is forced to cash after the month-end. The opportunity to reinvest is gone until the following month-end. Investors suffer opportunity costs of one and, in some cases, two months' return while waiting for their redemption proceeds. Not providing the proceeds from redemption on a timely basis is like imposing a redemption charge indirectly to the investor. At a minimum, 90% of monies should be paid to the investor within five day's following month-end. The faster the money is sent to the investor, the more likely the investor will convey a positive experience to other investors if asked in the future.

Rule 7: Know your limitations

Managers should be open when starting a fund with regard to its ultimate size. If a manager has never run a performance-based fund, they should impose a size limit the fund will remain open to new capital to. This conveys discipline to investors. Once the limit is reached, the manager can opt to raise the limit with consent from investors. If the fund is successful, the investors will want to add to their investment, and will gladly raise the limit It also provides an opportunity to remarket the fund to existing investors. Sometimes, sending a note to investors that the fund's limit is near, and the fund will be closing for an undeterminable time following the limit being reached, is enough to draw more capital in. It is worthy of mention that many desirable funds are often those that are closed, whether the performance warrants it or not. It's the fact that investors know the manager is prudent and knows his or her limits

Rule 8: Communication isn't everything, but when everything isn't working, it's critical to have

Communicating with investors regularly is important. The communication doesn't just serve to keep investors abreast of what the fund is doing, and how management sees the investing universe, it also helps maintain a perception of openness between a manager and the investors. When times are tough, and history proves they will be, investors are more likely to stay if they feel a strong communication link with the manager. When an investor has a concern, calling the manager who has provided an open line of communication is more likely than calling a manager who they have never spoken to. In the latter case, it is easier to just redeem.

Rule 9: Managers should keep in mind that a lawyer's job is to protect the fund's manager, not its investors

Managers often default to the advice from a hedge fund lawyer when drafting the documents for a fund. Managers must consider the impact the advice will have from an investor's perspective. Using a little common sense, and putting themselves in the investor's shoes when drafting an Offering Memorandum can be just as effective at attracting high quality investors as a great track record. High quality, high-net-worth investors will not tolerate one-sided conditions that reward failure or marginalize the investor's best interest.

by Jeff Banfield, JMO Research

Rule 10: Reporting insiders' holdings of funds

It is paradoxical that managers wouldn't consider investing in a public company that didn't report all insiders' holdings and update changes in their holdings promptly. Yet, the same managers expect their clients to do just this. Very few managers provide evidence of their full investment in the fund. Investors are more confident of a manager who provides all insider investing activity in their funds unsolicited, as well as maintains and enforces an internal policy in line with public companies reporting requirements. A fund that resists reporting what insiders' exact holdings and purchase and sale activities are, all but admit the management of the fund lacks confidence in the fund. It is a very serious oversight by regulators that insiders of hedge funds are not required by law to regularly report all insider holdings in their funds. It is just as serious an oversight by hedge fund managers if they assume their clients don't notice this.

Jeff Banfield
JMO Research
banfield@jmoresearch.com
Tel: 416.831.0105

Chapter 9

The Costs and Benefits of Changing Administrators

How to Start and Grow a Successful Hedge Fund in Canada

by Mackenzie Crawford, CommonWealth Fund Services

Introduction

A fund manager's relationship with their administrator is critical to the smooth operation of a fund as it launches and grows.

Before choosing an administrator, managers research the options and features offered by different service providers and generally consult with colleagues in the industry. Usually, once the service provider is chosen, and even if the service offering is not optimal, there is a reluctance to consider switching.

Often managers assume that they will have to pay more for better service and features. Many are simply unaware of the new service levels offered by administrators who have made enhancements to their offering.

Taking this stance amplifies the problem the Canadian hedge fund industry has as a whole since there are no repercussions for the administrator for under-servicing a fund. Penalizing an administrator by taking business away would encourage them to make improvements, invest in technology, offer competitive prices, and ensure Canadian managers can find a suitable service offering close to home. As an industry, the goal should be to strengthen Canadian providers, rather than outsource this function to other countries.

The reality is that various administrators offer unique advantages to certain fund managers. Not everyone has the same technology; not everyone has the same brand name. Some position themselves with a more competitive price, while others maintain a higher minimum causing them to be more expensive for small- to mid-sized funds. Every administrator in Canada is the right choice for somebody; but undoubtedly, some managers are not working with the best administrator for their specific needs.

Switching Administrators

Once a decision has been made to contemplate a switch, the important things to consider are: technology, company structure, client profile, and cost.

Technology

In Canada, technology ranges from systems built in-house, to some of the most widely used and reputable platforms in the world. While the largest administrators can often afford to invest the most in top technology, once this technology is in place, it can be very difficult to change. Smaller administrators may be more flexible when it comes to navigating changing requirements and handling industry updates.

Managers need to find the administrator with the technology that can best handle their structure and strategy with confidence. Managers need to consider the administrator's brand name, job execution, client profile, and, of course, costs, but the technology fit is critical. They must also be tested on their business continuity and disaster recovery plans, as managers will be asked about this as part of their investors' due diligence enquiries.

Two most important concepts when evaluating technology systems are:

- Straight-Through Processing; and
- System Integration.

by Mackenzie Crawford, CommonWealth Fund Services

Systems that are able to pull data, compute calculations, and export reports electronically, without the need for re-keying or manual intervention, are considered to be a straight-through process. The more straight-through, the fewer opportunities there are for human error, and the faster the process should be. System integration is the process of bringing together subsystems into one system and ensuring that the subsystems function together. The best example of this would be the two pillars of fund administration: fund accounting and shareholder record-keeping. Most administrators utilize two systems for these two functions, while some newer systems offer a single platform integrating both components.

Company Structure

In Canada, fund administration firms range from privately-owned entrepreneurial ventures with a foundation in Canadian fund accounting, to multi-national corporations choosing to operate in Canada to expand their global reach. Some are divisions of large banks, the fund administration divisions of which represent only a piece of their overall service offering.

Each has its own benefits, and careful consideration must be given by the manager as to the type of firm to partner with. If the fund's investors are primarily located offshore, then there may not be a need for an administrator with strengths in Canadian income tax or FundSERV processing. If hedge funds are just a part of the product offering, or if the fund's investors are primarily institutions, then there would be benefits in working with a bank affiliated administrator.

Key considerations when choosing an administrator include the number of employees, company culture, mission and vision, and responsiveness.

Client Profile

It is also important to consider an administrator's current client profile. A manager of a Canadian hedge fund may not want to engage an administrator that largely services mutual funds, or offshore funds, for example. The expertise required to service each type of fund differs, as does the systems necessary to support a specific segment of funds.

Cost

The costs of changing may appear obvious. The monetary cost can be confirmed by receiving quotes from potential administrators. Managers should also be aware at the outset of any potential exit or transition costs from the incumbent service provider. Any such costs should be clearly specified in the service agreement, and should be reasonably limited to the actual amount of time spent in supporting a conversion to a different firm. Some administrators may assist in the conversion on the receiving end to reduce the exit fee as much as possible, while others charge no exit fee whatsoever.

Going through the process correctly can take some time. Most managers looking to change administrators have grown to a point that they have some new service requirements, and, therefore, have the capacity to pay for an enhanced service. In another scenario, a fund's assets may have shrunk meaning they are being charged a minimum fee, making their management expense ratio (MER) higher than it once was. In both cases, a fee structure which reflects the current size of the fund and current service requirements may be easier to agree with a new administrator than the incumbent service provider.

by Mackenzie Crawford, CommonWealth Fund Services

Another cost to consider is the risk of service interruption, or even reduced levels of service. One option to consider is to run in parallel with two administrators until you have satisfied yourself on the new administrator's ability to deliver. Given the fierce competition in the industry, in some cases it may be possible to reduce administration fees while upgrading service.

Conversion

How easy or difficult the conversion process will turn out to be is largely dependent on the capabilities of both the incumbent and the newly-selected administrator. If there are two advanced systems speaking to each other, a full conversion can literally be done in a day. It is advisable, however, especially if the incumbent administrator drags their heels on data output, to allow five to six months for the conversion. This allows ample time for research, for giving notice to all parties involved, and to gain comfort on the new set up.

Closing Thoughts

Unlike some other jurisdictions, there are no licensing or regulatory requirements on fund administrators in Canada. The evaluation of who to work with, at initial selection or in the case of a conversion, rests squarely on the manager's shoulders. With so much attention on the manager's compliance with governing bodies such as the OSC, CSA, IIROC, and the CRA, it is interesting that there is less oversight on the service provider performing the key back office support services.

Membership in industry associations such as IFIC and AIMA is a good way for the administrator to stay up to date on important issues, but membership is not a requirement.

There are also no capital requirements. In some offshore jurisdictions the administrator has to put up $500,000 to operate in that market. This ensures that those who choose to put up the capital are committed to their offering.

One important element of oversight that is available is the CSAE 3416 Internal Audit & Controls report issued by an independent accounting firm. This report outlines the controls and procedures of the administrator, and the testing and results conducted by the independent auditor.

There is room for improvement in the oversight of administrators in Canada, but, in the meantime, it is important for the manager to ask all the right questions when completing a launch or a conversion.

Mackenzie Crawford
Vice President
CommonWealth Fund Services
mackenzie@commonwealthfundservices.com
Tel: 416.687.6654

Chapter 10
Seven Questions to Ask Your Prime Broker

by Daniel Dorenbush, Scotia Capital Inc.

Introduction

Prime brokers (PBs) are essential, value-added partners for emerging and well-established hedge funds. They act as a gateway to a wide range of products and services provided by an investment dealer to hedge funds. These products and services are needed to launch and grow a fund, as well as to efficiently manage a fund's ever-evolving operational, financing and reporting needs.

Following the lessons learned from the credit crisis in 2008–and as the range of products and services prime brokers offer continues to grow in depth and complexity–it is becoming increasingly more important to apply a well-researched approach to selecting a prime broker.

There are, of course, a number of industry standard due diligence questionnaires available, such as those from the Alternative Investment Management Association (AIMA), to help with the prime broker selection process. What follows are some additional questions which we suggest hedge funds pose to the prime brokers during the selection process.

What is the commitment level of your organization to the prime brokerage business?

While some dealers have been fully and consistently committed to the prime brokerage business, others have waxed and waned over the years. The level of commitment can be gauged by these three factors:

- the prime brokerage-specific experience of the PB leadership team;
- the operational and technological investments the firm is making in PB, and
- the size of the business today versus five years ago, including number of staff, number of clients, assets under management (AUM), strategies and domiciles supported, as well as existing clients' geographic locations.

The answers to these three questions will begin to paint a picture of where the PB business has been within the overall framework of the investment bank and where it is going. A strong PB platform should have many of the following:

- a multi-year strategic plan (that is not completely revamped periodically);
- ongoing and meaningful investments in technology and operational infrastructure;
- an expanding client base;
- growing AUM;
- an increasing headcount; and
- the ability to service a broader spectrum of strategies over time.

A PB that possesses these characteristics has its own momentum and can be seen as an engine of growth rather than a drain on resources for its parent. Additionally, putting together seasoned teams with substantial PB-specific experience shows commitment on the part of the investment bank to hire and retain talent for the benefit of their clients.

Seven Questions to Ask Your Prime Broker

by Daniel Dorenbush, Scotia Capital Inc.

How did your PB business respond to the extreme market conditions of 2008?

Historic behaviour can clearly be a meaningful guide to future behaviour, so knowing how a PB reacted during a period of market stress will be of interest to a prospective hedge fund manager. Observing how a PB behaved during a market 'dislocation', such as occurred in 2008 will be instructive. Did the PB modify client margin and financing rates and were those changes across the board (possibly reflective of an overall change in appetite for the business), or were they simply applied against specific clients or asset classes? Moreover, how effectively were those changes communicated and implemented and over what timeframe?

Often changes by a PB are prudent and required, but working with clients as knowledgeable business partners rather than simply service providers allows PBs to come out of crisis periods, with stronger relationships and better regarded businesses than before. Just as communication is critical between investors and fund managers, how a PB communicates and provides service through difficult periods is paramount to any longer term relationship.

How are you differentiated from your competitors?

The last three to five years have seen a marked change in the Canadian PB landscape. Prior to this, PB platforms in Canada were arguably very similar. A few of the global prime brokers planted flags in Canada as they identified a gap between their capabilities and that of domestic PBs. Over the last few years, Canada's PBs have essentially followed strategies of retrenchment, maintenance, or growth. As a result, Canada's PBs have evolved very different product offerings. Additionally, the capability gaps that once existed between global and domestic PBs has been meaningfully reduced by some organizations that have pursued a more broad-based global growth strategy.

Some Canadian PBs now have well-developed abilities to facilitate shorts in international markets and offer both cash and synthetic prime brokerage. Synthetic prime brokerage provides flexibility and improved economics, in certain cases, that 'cash' prime brokerage cannot offer. Some Canadian PBs offer services in the US. This is useful if, as a Canadian manager, you attract US high-net-worth or institutional investors; a Canadian PB with a global platform can potentially facilitate the US business. Certain PBs can act as both custodians and dealers to minimize operational requirements for closed-ended funds and facilitate tri-party structures so that assets held at another firm can potentially provide margin for the PB account.

A broad product offering indicates a PB who has climbed the ladder of sophistication and is serious about the business.

What department does the securities lending desk report into and where does supply come from?

Size is not the only factor when it comes to evaluating a stock loan desk–easy borrow names are simple to source. A good stock loan desk is one that is hungry. Traders are connected through global stock loan platforms and want to go the extra mile to source difficult names that other PBs may not be able to find. If a stock loan desk reports into a department other than PB, or has a shared reporting line, PB clients may not be their top priority. A good stock loan desk continually adds new supplier relationships and builds their arsenal of contacts to call for truly difficult names. Your PB should have exclusive arrangements with some lenders, as is common in the US and Europe, in order to offer clients private access to a supply of inventory.

by Daniel Dorenbush, Scotia Capital Inc.

How closely does the prime brokerage business work with the other departments in your organization?

Maintaining confidentiality of your positions, particularly within the trading segments of investment banks, is of paramount importance. However, that doesn't mean your PB cannot work in a logical way with other departments in the organization to help your business. Where appropriate, communication across the PB, direct market access, equities, fixed income/credit, derivatives and foreign exchange desks to facilitate new accounts or provide value-added solutions to client needs can be made as seamless and simple as possible. A good PB knows how to work well with other departments in order to introduce new and relevant product offerings and produce the best solutions for your business.

How does your prime broker facilitate capital introduction?

In an environment where capital raising for emerging managers has become challenging and the bulk of new investment flows have been channelled to some of the largest global hedge fund firms, capital introduction (cap intro) has become an increasingly important value-added service to PBs. Within a Canadian context, cap intro offerings vary among Canadian prime brokers, ranging from non-existent to dedicated teams who work meaningfully with managers and a broad swath of investors. Some Canadian PBs offer cap intro through third-party service providers. In-house programs typically have dedicated resources focused on three functional areas.

The first is working with funds on their product offering, identifying differentiating factors from other funds. The next step is to refine the 'pitch' and presentation to speak best to the chosen investor channel, be it retail distribution, high-net-worth investors, family offices or institutions such as endowments and pension plans. PBs should also work with clients to develop a long-term plan, setting goals to reach certain milestones, such as performance numbers, infrastructure enhancement, key hires and minimum asset levels, so that the PB's investor network will be increasingly eager to meet with you.

The second service a cap intro team can facilitate is an understanding of the investor landscape. This is done through deep investor relationships and being knowledgeable on the changing needs, requirements and appetites of those investors.

Finally and perhaps most importantly, a cap intro team facilitates targeted introductions which do not rely on a 'shot-gun' approach; spending time presenting to unqualified or un-motivated allocators is clearly a less than optimal application of a manager's energy and resources.

What are your shortcomings?

Every business has limitations. Good PBs can identify both their strengths and their shortcomings, and are candid about discussing them with you. The best service providers execute a clear plan to continually improve their business to support you better.

Great care should be exercised by a fund manager in choosing a PB given the almost symbiotic nature of the relationship they should develop over time. Fund managers not only rely on their PBs to facilitate their key financing needs, but will generally be required to harmonize their systems, operational processes and infrastructure so that managers can focus on managing portfolios and generating alpha for investors.

by Daniel Dorenbush, Scotia Capital Inc.

While this is certainly not an exhaustive list, a prospective PB's response to these questions should provide a hedge fund manager with a much better picture of their capabilities and commitment to what is hoped will be a productive and long-term relationship.

Daniel Dorenbush
Managing Director, Prime Services
Scotia Capital Inc.
daniel.dorenbush@scotiabank.com
Tel: 416.863.3991

Chapter 11

Considerations for Canadian Managers Operating Non-Canadian Funds

How to Start and Grow a Successful Hedge Fund in Canada

by Gwyneth Rees and Jeremy Bomford, Maples and Calder, Cayman Islands

Expanding Offshore

When a Canadian hedge fund manager has built up a successful track record using a domestic Canadian fund vehicle, as a logical next step it may wish to use the same investment strategy to attract international investment.

This will generally involve setting up an offshore fund structure. The Cayman Islands, in particular, have established themselves as a pre-eminent centre for this type of work, with the majority of the world's hedge funds being domiciled in the jurisdiction (estimates typically range between 70% and 80%). The Cayman Islands model, based on tax neutrality and professional efficiency, has been reviewed extensively by managers, investors and their advisers over the years and is regarded as a tried and tested solution, robust enough to withstand the challenges of the 2008 financial crisis and the subsequent market turbulence.

Fund Structuring

The offshore hedge fund structure most commonly used for non-US and US tax-exempt investors is the Cayman Islands corporate fund (ie, the exempted company), either as a standalone vehicle or as part of a master-feeder structure. The traditional master-feeder structure for a hedge fund will typically involve a Cayman Islands corporate feeder fund (for US tax exempts and non-US investors) and a Delaware limited partnership as a US pass-through feeder fund (for US taxable investors), each investing into a Cayman Islands corporate master fund (which makes the appropriate election to be regarded as transparent for US tax purposes). The master fund will generally hold all the assets and carry out the trading activities in this structure. While there can be variations on the theme (for example to ensure management and performance fees/allocations can be taken out in the most tax-efficient manner) this common structure generally allows international investors with different tax treatments to invest in the same fund in a tax-efficient manner for all concerned. In addition to these tax efficiencies, the consolidation of investment capital in the master fund increases the level of overall fund assets and so can reduce trading and operational costs through economies of scale.

The Canadian Dimension

When establishing an offshore hedge fund for a Canadian manager, two key issues to address from the outset will be the 'mind and management' of the fund and whether the fund is carrying on business in Canada as a result of the Canadian management. Under Canadian tax legislation, there is a 'safe harbour' provision which specifies designated investment services that may be carried on by the Canadian manager of an offshore hedge fund without risk of causing the fund to be carrying on business in Canada and thereby subjecting the fund to Canadian tax. These designated investment services include investment management and advice with respect to qualified investments. However, any activities constituting mind and management control of the fund occurring in Canada, such as general governance authority, would fall outside the safe harbour provision and also could cause the fund to be resident in Canada, and thus taxable there. The precise tax analysis can differ as between different Canadian advisers, and it is important that managers work closely with their legal counsel and tax advisers to obtain the appropriate advice on Canadian tax issues. For example, there may be sensitivities around the location of the other service providers to the fund (eg, the administrator), the board of directors of the fund (and master fund), and the holder(s) of any

by Gwyneth Rees and Jeremy Bomford, Maples and Calder, Cayman Islands

non-participating voting shares in the fund, among other things. Canadian tax advisers will generally advise that not only must ultimate legal control reside outside of Canada, but that *de facto* control must also be maintained outside Canada, and to that end certain advisers will recommend that as many services as possible be provided outside of Canada for Canadian-managed offshore hedge funds. This is generally achieved by implementing the following types of measures:

(a) appointing an administrator and other service providers for the fund that are located in the Cayman Islands or another jurisdiction outside of Canada;

(b) appointing a board of directors for the fund that comprises at least a majority (if not all) independent directors that are not resident in Canada (there are a number of providers of professional independent directors based in the Cayman Islands);

(c) ensuring that the fund's governance takes place outside of Canada; and

(d) where the fund issues participating non-voting shares to investors, having the non-participating voting shares in the fund (typically referred to as 'founder' or 'management' shares) held independently of the fund manager and its affiliates–for example, arrangements would typically be made for the voting shares to be held in charitable trust and particular care should be taken to ensure that the charitable trust documentation satisfies the requirements that independence and control are maintained outside of Canada.

In addition, restrictions apply in relation to the promotion and sale of shares in the fund to Canadian investors, so the Canadian fund manager may not want to admit its Canadian investors directly into the Cayman Islands fund it manages. In certain circumstances it may be possible to establish a blocker fund, or series of blocker funds, to address this concern.

Canadian Tax Treaties and Cayman Enterprise City

Historically, Canada has had strong links with Barbados due to its double tax treaty with the jurisdiction, which essentially allowed certain profits made by a Barbadian foreign affiliate of a Canadian resident corporation to be repatriated to Canada tax-free after paying lower taxes in Barbados. The Cayman Islands signed a Tax Information Exchange Agreement with Canada which became effective on 1 June 2011, effectively allowing the same practice as between a Cayman Islands resident foreign affiliate and its Canadian resident corporate parent (as a result of the Cayman Islands being considered a designated treaty country for the purposes of the Income Tax Act of Canada). The advantage in using the Cayman Islands, however, is that there is no tax payable at the Cayman Islands stage of the process (unlike Barbados), nor are there any exchange control restrictions or regulations in the Cayman Islands.

The Cayman Islands has also established a special economic zone, known as Cayman Enterprise City (the CEC), where Canadian businesses may quickly and easily set up a substantive offshore base with a real corporate presence and 'mind and management' in the Cayman Islands. The CEC comprises a number of specialist business parks, aimed at the internet, technology, academic, media, film, biotech, and commodities and derivatives industries, and combines the tax and jurisdictional benefits of the Cayman Islands with a number of government-mandated measures designed to attract new business (including exemptions from work permits, taxes and import duties, and a guaranteed 10-day, fast-track set up of operations). Accordingly, the Cayman Islands offers significant opportunities for Canadian businesses looking to establish a tax-neutral offshore presence in a designated treaty country.

by Gwyneth Rees and Jeremy Bomford, Maples and Calder, Cayman Islands

Cayman Islands Management Companies

For managers looking to form a Cayman Islands-domiciled management company but without a physical presence in the Cayman Islands in the CEC, an alternative is to take advantage of the streamlined licensing regime available in the Cayman Islands under the Securities Investment Business Law (SIBL).

Where the Cayman Islands management company conducts its operations mainly outside the Cayman Islands and provides investment management services exclusively to a Cayman Islands hedge fund registered with the Cayman Islands regulator, being the Cayman Islands Monetary Authority (CIMA), it will typically be able to avail itself of an exemption from the full licensing regime under SIBL in return for filing an annual declaration with CIMA and paying an annual fee (approximately US$6,000 at current rates).

The Cayman Islands fund management company would, in addition, be required to maintain anti-money laundering procedures that comply with the Cayman Islands regime, including reporting suspicious activity and the appointment of a Money Laundering Reporting Officer. These procedures can be delegated to a suitable third party, provided that the delegation is formalized in an appropriate agreement.

Regulatory Framework and Compliance (Initial and Continuing Requirements)

'Mutual funds' have been regulated in the Cayman Islands since 1993. Under the Cayman Islands legislation, the term 'mutual fund' in fact equates to 'investment fund', rather than equating to regulated retail funds (which is the US context for the term). Only 'mutual funds' that carry on business in or from the Cayman Islands are subject to regulation by the Cayman Islands authorities. Responsibility for such regulation rests with CIMA.

What is a 'mutual fund' under Cayman Islands law?

Under the Mutual Funds Law (2013 Revision), a 'mutual fund' is defined to mean any company, unit trust or partnership (wherever established) which issues equity interests redeemable at the option of the investor, the purpose or effect of which is the pooling of investor funds with the aim of spreading investment risks and enabling investors to receive profits or gains from investments. In a typical Cayman Islands master-feeder structure, both the feeder fund and the master fund will generally be 'mutual funds' for these purposes (unless an exemption applies – see below).

Although the Cayman Islands definition is a wide one, some investment funds are still excluded from the definition and, consequently, from regulation. Funds that do not qualify as a 'mutual fund' include closed-ended funds (where the investors cannot redeem at their own option), single investor funds that are not master funds to a CIMA regulated feeder fund (because there is no 'pooling of investor funds') and funds that issue debt rather than equity interests.

Is a fund carrying on business from the Cayman Islands?

Subject to the exemption referred to below, funds established in the Cayman Islands are subject to regulation and foreign funds will be caught by the regime if they are carrying on business from the Cayman Islands. It is a question of fact whether a fund is carrying on business from the Cayman Islands, although funds which (irrespective of their domicile) make an invitation to the public in the Cayman Islands to subscribe for interests will be caught by the regime.

by Gwyneth Rees and Jeremy Bomford, Maples and Calder, Cayman Islands

What funds are specifically exempted from regulation?

Not every fund that carries on business from the Cayman Islands is required to be regulated by CIMA. If the number of investors is conveniently small and control of the mutual fund lies with the investors or if appropriate regulation is already in place (ie, the fund is listed or regulated by an entity recognized by CIMA and marketed by a CIMA regulated entity) the fund may qualify for an exemption from registration under Section 4(4) of the Mutual Funds Law.

Types of Regulated Funds

Regulated funds in the Cayman Islands fall into three categories:

(a) registered funds;

(b) administered funds; and

(c) licensed funds.

Administered funds and licensed funds have no minimum investment thresholds, but more onerous registration and licensing requirements – they are aimed more towards the retail investor. Since sophisticated and institutional investors have been, and remain, the focal point of the Cayman Islands funds industry, the majority of funds fall to be regulated as registered funds under Section 4(3) of the Mutual Funds Law.

Essential Requirements to Qualify for the Regime

A fund qualifies under Section 4(3) if:

(a) the minimum initial investment per investor is at least US$100,000 or the equivalent in any other currency; or

(b) the equity interests are listed on a recognized stock exchange.

Provided the initial investment amounts to US$100,000 or more, subsequent investments can be made in smaller increments and interests may be redeemed, withdrawn or repurchased leaving an invested amount of less than US$100,000.

Registrations / Permits / Licences Required

No prior approval is required for the registration of a fund falling within Section 4(3). The registration process is straightforward and the statutory requirements are satisfied simply by filing the appropriate documentation and payment of the appropriate fee (see details below). There is no consideration or assessment period and, provided the appropriate documents have been filed and the fee paid, the fund will be registered immediately and automatically as a regulated mutual fund. Once registered, the fund is able to market its interests and accept subscriptions without delay.

Once the documents have been filed, CIMA will actively review them and may require additional information from the fund, require amendments to the documentation or take other appropriate steps. Recently, CIMA has taken a very proactive role in reviewing documents and seeking further information.

by Gwyneth Rees and Jeremy Bomford, Maples and Calder, Cayman Islands

Documents it is Required to File

Subject to any exemption that is specifically granted, the documents to be filed in order to register a typical feeder fund or standalone fund as a regulated fund under Section 4(3) are:

(a) an offering memorandum;

(b) the Form MF1;

(c) a copy of the certificate of incorporation of the fund;

(d) a written consent of both the fund's administrator and the fund's auditor confirming acceptance of their appointment by the fund; and

(e) an affidavit in support of registration from a director of the fund, together with certain details (place of birth, date of birth, email address) for all directors of the fund.

The documents to be filed in order to register a master fund under Section 4(3) are:

(a) the Form MF4;

(b) a copy of the certificate of incorporation of the master fund;

(c) the master fund offering memorandum–but only if there is one; and

(d) a written consent of both the master fund's administrator and auditor confirming acceptance of their appointment by the master fund–these may be included in the same consent letter as for the regulated feeder fund where the administrator and auditor are the same for both and the filings are made at the same time.

The offering document must describe the equity interests in all material respects and contain such other information as is necessary to enable a prospective investor to make an informed decision whether or not to invest. While the Mutual Funds Law does not specify detailed contents requirements, CIMA has developed its own checklist for use in reviewing the offering document and which, in practice, constitutes mandatory requirements. Most well drafted offering documents should, however, contain the relevant information as a matter of course.

Registration / Permit / Licence Fees – Initial, Ongoing and Upon Termination

The fee payable on registration is currently US$4,268 for a typical Cayman Islands feeder or standalone fund, and US$3,048 for a typical Cayman Islands master fund. In each case, the registration fee covers the balance of the calendar year in which the fund is registered.

Thereafter, the prescribed annual registration fees, also US$4,268 or US$3,048 (as applicable) at current rates, are payable on or before 15 January in each year until the fund de-registers as a mutual fund or its status is formally changed to 'license under termination' or 'license under liquidation', whereupon it will be partly or wholly released from the obligation to pay fees. There is also an annual filing fee of US$365 payable in connection with the filing of the fund's annual return and audited accounts with CIMA. Formal steps must be taken with respect to any de-registration or change in status and, until those steps have been taken, the obligation to pay fees continues irrespective of whether the fund is actually conducting business, and there are penalties for late payment.

by Gwyneth Rees and Jeremy Bomford, Maples and Calder, Cayman Islands

Requirements for Local Service Providers

There are only two statutory requirements as to the use of local service providers: the registered office and the auditor of a registered fund must both be based in the Cayman Islands.

Since almost all Section 4(3) funds carry on business mainly outside the Cayman Islands, the registered office requirement is usually fulfilled by retaining a registered office provider who will assist in making government and regulatory filings.

There are no further requirements for local service providers to be appointed by the fund, and onshore administrators or custodians may be appointed.

Requirements as to Directors

In the context of a Cayman Islands corporate fund, there are no statutory requirements as to board composition, residency or as to the number of board meetings to be convened each year. However, as a matter of policy, CIMA requires the fund to have a minimum of two directors who are natural persons and are identified in the offering document, and the fiduciary duties owed by the directors require them to hold as many meetings as are necessary for the fund to operate effectively. CIMA has also issued further guidance on corporate governance matters for the funds it regulates (see further below on this).

Operating and Selling Restrictions

There are no restrictions on a Section 4(3) fund's investment objectives or policies, risks, rates of return or its power to borrow (other than those the fund chooses to set out in its offering materials and constitutional documents), nor is there any requirement for annual shareholder/investor meetings. The sophisticated investors at which these products are aimed are left free to make their own determination as to whether or not to invest, and generally the marketing and selling of these products will be according to the securities laws and regulations of the relevant investor's own jurisdiction. In this way, the Cayman Islands avoids imposing the expense and administrative burdens of such regulation directly on the funds. No offer or invitation to subscribe for interests in the fund may be made to the public in the Cayman Islands (unless such interests are listed on the Cayman Islands Stock Exchange) but the 'public' in the Cayman Islands does not include 'sophisticated persons', 'high net worth persons' or various exempted Cayman Islands entities.

Ongoing Obligations – CIMA Related

Financial Reporting

All mutual funds must, unless specifically exempted, file audited accounts signed off by a Cayman Islands-based auditor within six months of the financial year-end. For funds which register in the second half of their financial year, it is possible to avoid the administrative burden and expense of an audit at the end of the first trading year, by electing for an initial fiscal year end which ends up to 18 months (but no more) from the date of registration.

by Gwyneth Rees and Jeremy Bomford, Maples and Calder, Cayman Islands

CIMA also requires that each registered fund file a Fund Annual Return (FAR) form with the annual audited accounts in electronic format. The electronic FAR form, containing a summary of basic information about the fund, is filed annually by the fund's local auditors, although the operators of the fund remain responsible for the accuracy of the contents of these forms.

Fund Documentation

No annual updates are required to the fund's constitutional documents or offering materials. However, where there is a continuing offering of securities or interests, a fund will be deemed not to be compliant with the relevant provisions of the Mutual Funds Law where there are any material changes in the information contained in the offering memorandum or in the prescribed details filed with CIMA and the updates are not filed with CIMA within 21 days of the fund's promoter or operator becoming aware of the material changes. Where there is a change in registered office or operator, both the appropriate Cayman Islands Registry and CIMA should be informed and the relevant registers must be updated within 30 days of the change, failing which penalties will be incurred. Where there is a change to the auditor or administrator, a consent letter signed by the newly-appointed auditor or administrator will also need to be filed with CIMA.

Anti-Money Laundering (AML)

Regulated funds have ongoing AML obligations, although this function will commonly be delegated to the fund's administrator, since it is the administrator that, in practice, will be receiving and processing subscriptions for the fund, including the necessary 'know your client' information required under applicable AML laws. In delegating the AML function in this way, the fund must ensure that:

(a) the administrator agrees under the administration agreement to take responsibility for AML;

(b) the administrator does so on behalf of the fund (not just itself); and

(c) the administrator is either in the Cayman Islands or a country recognized as having equivalent AML requirements to the Cayman Islands, is subject to that country's AML requirements and agrees to conduct AML in accordance with that country's requirements.

Other Requirements

CIMA may, from time to time, seek specific information in respect of a particular fund or funds generally, including for AML purposes or to respond to a request from a fellow regulator in another jurisdiction (eg, CIMA has memoranda of understanding and other information-exchange agreements with financial regulators in various countries, including Canada, the UK and the US).

In addition, as noted above, there are prescribed procedures which must be followed in order to deregister a regulated fund, failing which the above reporting and filing requirements continue to apply regardless of whether the fund has, as a practical matter, ceased operations.

by Gwyneth Rees and Jeremy Bomford, Maples and Calder, Cayman Islands

Additional Ongoing Obligations

Cayman Islands hedge funds must conduct their affairs in accordance with their constitutional documents and the requirements of the law generally. These will include fiduciary duties of the directors plus statutory obligations to the fund, namely:

(a) to keep proper books and records;

(b) to notify the Cayman Islands Registrar of changes in name or other registered details;

(c) to file annual returns and pay annual fees; and

(d) in the case of exempted companies, to maintain the relevant registers (ie. of directors and officers, shareholders, mortgages and charges over company property) at the fund's registered office in the Cayman Islands.

Taxation

The Cayman Islands have no direct taxes of any kind. There are no income, corporation, capital gains or withholding taxes, nor are there any death duties. Under the terms of relevant legislation it is possible for the fund to register with, and apply, to the government of the Cayman Islands for a written undertaking that it will not be subject to various descriptions of direct taxation, for a minimum period, which in the case of an exempted company is usually 20 years. In addition, there are no exchange control restrictions or regulations in the Cayman Islands (unlike many other jurisdictions, including some of the Cayman Island's offshore competitors) so monies can be freely transferred in and out of the Cayman Islands, subject to anti-money laundering laws and regulations.

Cayman Islands hedge funds therefore provide a tax-neutral base in which to combine investors from a number of jurisdictions investing in assets located in the same or other jurisdictions. This neutrality is often important because it provides a level playing field for all investors and avoids creating a vehicle in a jurisdiction that may favour some investors more than others. This does not affect investors' obligations to pay tax in their jurisdiction of residence: it simply removes what would otherwise be an extra layer of foreign taxation at a particular level of the structure.

In addition, the Cayman Islands is a co-operative and transparent jurisdiction in relation to the exchange of tax information. It has signed 34 Tax Information Exchange Agreements (of which 27 have been brought into force), with a further 16 agreements in negotiation. It has laws that require automatic reporting to EU tax authorities on Cayman Islands bank accounts held by EU residents. Cayman Islands authorities co-operate with governments worldwide to ensure that the Cayman Islands cannot be used to evade home country taxes. The Cayman Islands Government is actively co-operating on initiatives such as the US Foreign Account Tax Compliance Act (FATCA), the Organisation for Economic Co-operation and Development Convention on Mutual Administrative Assistance in Tax Matters, and the G5 countries' pilot project on the automatic exchange of tax information.

Considerations for Canadian Managers Operating Non-Canadian Funds

by Gwyneth Rees and Jeremy Bomford, Maples and Calder, Cayman Islands

Recent Cayman Islands Developments

Governance

The conduct of the business of a Cayman Islands hedge fund is the ultimate responsibility of its board of directors in the case of a company. In practice, however, since a hedge fund will typically have no employees, the board of directors will delegate the day-to-day management and administration functions to professional third-party service providers–ie, the investment manager, administrator, prime broker/custodian, etc. These service providers will report to the board, which will periodically meet to discuss/review the performance of these delegates and the fund generally.

The role of the board of directors of a Cayman Islands hedge fund was considered by the Cayman Islands Grand Court in its landmark judgment released on 26 August 2011 in *Weavering Macro Fixed Income Fund Limited (in liquidation) v Peterson and Ekstrom*. This was the first time the Court had specifically considered the duties of independent non-executive directors of an offshore hedge fund and the judgment made clear that the Court takes the issue of hedge fund governance very seriously.

Whilst it was common ground in the case that the directors, being independent non-executive directors, had a 'high level supervisory role' to perform, the judge also made a series of statements about the duties of hedge fund directors and how they should be discharged throughout the various stages of the life of a fund. Directors are expected to be proactive, make their own enquiries and not simply react to whatever problems or issues may be brought to their attention by the other service providers, with emphasis being placed on the need for proper documentation evidencing how the directors are discharging their duties to the fund.

CIMA, as the Cayman Islands hedge fund industry's regulator, issued its final form Statement of Guidance on Corporate Governance for Regulated Mutual Funds (SOG) on 13 January 2014, following a consultation process with industry stakeholders. The SOG is intended as non-exhaustive guidance for fund directors and operators on CIMA's minimum expectations for the sound and prudent governance of a CIMA regulated fund. It outlines key management oversight principles, including CIMA's expectations in relation to directors' duties, frequency of board meetings and risk management, while recognizing that there is no 'one size fits all' answer, such that the adequacy and suitability of a particular fund's governance structure will need to reflect the actual circumstances of that fund (eg, its size, nature and complexity).

While not directly enforceable law, the contents of the SOG do echo a number of principles covered in the Weavering judgment mentioned above, and the SOG is further evidence of the importance accorded to having proper corporate governance practices in place from the outset. In addition, in March 2014, CIMA announced its proposals for a new regime for the registration of directors of CIMA regulated funds (and certain other covered entities) and the licensing of professional and corporate directors of such entities. At the time of writing (mid-April 2014), the new regime is expected to be passed into law and brought into force in the Cayman Islands imminently.

by Gwyneth Rees and Jeremy Bomford, Maples and Calder, Cayman Islands

Liquidity Issues

Funds are generally well advised to include broad and flexible language in their organizational documents to permit the directors latitude in how to deal with fund liquidity issues, depending on the investment strategy being used and what is appropriate in the context. For example, so called 'side pocket' provisions may be included if there is a significant likelihood as a result of the chosen strategy that certain assets in the portfolio may be, or become, illiquid or difficult to value. However, before the 2008 financial crisis this was not common practice for most hedge funds, and in the absence of suitable side-pocket provisions in the fund's organizational documents (or any prospect of obtaining investor consent to allow for them) alternative solutions had to be found to deal with illiquid assets.

The mechanisms employed as solutions to such liquidity problems can be broadly grouped into two categories:

(a) those which completely or partially restrict the investors' ability to exit from the fund (such as gates and suspensions); and

(b) those which enable redeeming investors to exit the fund, but allocate the illiquidity *pro rata* between both redeeming and continuing investors (such as payments in-kind and reserves/hold-backs).

There have been various well reported decisions in this area over the last few years, for example the Matador and Strategic Turnaround cases[1] in relation to suspensions and redemptions, and the Wyser-Pratte and Heriot cases[2] in relation to commercial (or so-called 'soft') wind-downs of funds. A key message from each is that considerable care must be taken in drafting a hedge fund's organizational and offering documents so that they clearly state the investors' entitlements on redemption and clearly state the fund's powers to restrict and/or deal with such entitlements, and management's power to wind-down the fund, in the event of extreme illiquidity or other extraordinary circumstances.

Side Letters

Hedge funds and their managers are sometimes asked to enter into a side letter granting special (generally preferential) terms to a particular, potentially significant, investor in order to persuade that investor to invest in the fund.

Side letters often give rise to complex issues that require a careful analysis of the relevant documents and surrounding circumstances in any particular case. For a side letter to be valid and binding on a fund, the directors must have the power to enter into such a side letter in the articles of association. Care should also be taken to ensure that the fund contracts with the appropriate party: under Cayman Islands law a person that is not a party to a contract generally may not enforce that contract, or have that contract enforced against them, directly. Recent case law has highlighted the importance of getting this right[3]. At the time of writing a new law is expected to be brought into force shortly, which, when in force, will allow for enforceable third-party rights to be provided for under Cayman Islands law governed contracts.

In addition: (i) the side letter must not contravene any of the terms of the articles of association of the fund or Cayman Islands law generally; and (ii) the directors of the fund must act at all times in compliance with the general duties (including fiduciary duties) which they owe to the fund and the other investors in the fund in deciding whether or not to enter into a side letter with a specific investor. Furthermore, the relevant offering materials should make specific disclosure of the intention to issue side letters and the specific nature of their proposed content.

by Gwyneth Rees and Jeremy Bomford, Maples and Calder, Cayman Islands

Any breach of these basic propositions may result in the side letter being unenforceable or place the fund in a position where it will breach the terms of the side letter or the articles of association. In extreme cases, the directors could be liable for breach of duty if the fund can show that loss resulted from the actions of the directors.

Even where a fund's governing documents expressly grant the directors of the fund a broad power to enter into side letters, they are still bound by a general fiduciary duty to act in good faith in the interests of the fund in deciding whether or not to agree to the terms of a side letter. It will be a question of judgment in any given case whether the directors or an investment manager has properly exercised its powers to enter into any given term of a side letter.

Onshore regulators such as the Ontario Securities Commission in Canada, the Financial Conduct Authority in the UK and the Securities and Exchange Commission in the US have focused on the use of side letters recently and recognized that side letters can give rise to difficult issues. Industry associations such as the Alternative Investment Management Association have also produced guidelines as to the use of side letters and appropriate disclosure of their terms in offering documents.

Onshore Tax and Regulatory Considerations

There are a number of onshore tax and regulatory initiatives beyond the scope of this chapter (such as the reporting requirements and withholding tax penalties in relation to certain US source income under FATCA, and the requirements of the EU Directive on Alternative Investment Fund Managers (the AIFMD) in relation to marketing in the EU) which may affect the operations of an offshore hedge fund outside of the jurisdiction, so it will be important for the fund, its manager and promoter to take legal, tax and regulatory advice in all other relevant jurisdictions.

Comparing Jurisdictions

This chapter has focused on the Cayman Islands, as the leading offshore jurisdiction for the formation of hedge funds. By way of comparison, set out in the table below are some statistics (current as at 31 December 2013) showing the number of registered funds in the Cayman Islands versus other main offshore jurisdictions best known as hedge fund formation domiciles, together with figures for Ireland and Luxembourg for informational purposes.

Jurisdiction	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Cayman	3,014	3,648	4,285	4,808	5,932	7,106	8,134	9,413	9,870	9,523	9,438	9,258	10,841^	11,379^
BVI	1,821	1,975	1,977	1,934	2,138	2,372	2,571	2,731	2,571	2,937	2,706	2,590	2,318	2,238
Ireland	2,392	2,870	3,300	3,507	3,712	3,798	4,087	4,780	5,025	4,627	4,743	5,069	5,305	5,599
Luxembourg	1,785	1,908	1,941	1,870	1,968	2,060	2,238	2,868	3,371	3,463	3,667	3,845	3,841	3,902
Malta	306	332	369	362	129	151	203	299	401	395	410	556	587	626*
Jersey	321	327	449	602	833	965	1,157	1,311	1,472	1,294	1,324	1,392	1,388	1,344
Bermuda	951	890	912	1,022	1,149	1,182	1,302	1,303	1,133	955	900	872	762	709**
Bahamas	757	673	706	707	838	709	723	782	803	788	753	713	652	652***

^ Includes master funds (2012 – excluding master funds = 8,950), (2013 – excluding master funds = 8744)
* estimated – statistic not available
** updated to Q3 2013
*** updated to Q4 2012

by Gwyneth Rees and Jeremy Bomford, Maples and Calder, Cayman Islands

Gwyneth Rees
Partner
Maples and Calder
gwyneth.rees@maplesandcalder.com
Tel: 1.345.814.5220

Jeremy Bomford
Partner
Maples and Calder
jeremy.bomford@maplesandcalder.com
Tel: 1.345.814.5381

Endnotes:

[1] *In re Matador Investments Ltd* (Grand Court of the Cayman Islands, Quin J, 27 August 2009), and *Culross Global SPC Limited v Strategic Turnaround Master Partnership Limited* [2010] UKPC 33.

[2] *Re Wyser-Pratte Eurovalue Fund, Ltd.* (unreported) 26 October 2010, and *Re Heriot African Trade Finance Fund Limited* (unreported) 4 January 2011.

[3] *Re Medley Opportunity Fund Ltd* (Grand Court, 21 June 2012), *Landsdowne Limited and others v Matador Investment Limited (in official liquidation)*, and *Swiss-Asia Genghis Hedge Fund v Maoming Fund* (Grand Court, 24 July 2013).

Chapter 12

Canadian Tax Treatment of Hedge Funds and Their Investors

How to Start and Grow a Successful Hedge Fund in Canada

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by Carmela Pallotto, KPMG LLP and Daniel Tworzewski, KPMG LLP

Introduction

The choice of structure for a hedge fund is influenced by many factors, one of which is tax. As hedge fund investors continue to seek high returns, it is important to minimize the tax that is paid on those returns at the fund level. Ideally, the fund should not pay any tax. However, depending upon the structure chosen and the investment and distribution strategies of the fund, it may not always be possible to achieve this goal.

The purpose of this chapter is to provide a summary of the Canadian tax rules applicable to hedge funds. The following are specific topics that will be covered in this chapter:

- the structure and taxation of the fund;
- the taxation of the fund's activities;
- the taxation of Canadian investors; and
- the taxation of the fund manager.

This summary is not meant to be legal advice and does not cover all the tax consequences that may apply to a particular fund or investor. Each fund and investor should consult a tax adviser for details about their particular situation.

Structure and Taxation of the Fund

A hedge fund may be structured as a limited partnership, trust or corporation. Regardless of the structure that is used, a hedge fund must calculate taxable income. Trusts or partnerships are often chosen as the vehicle for the fund because they are generally effective flow-through entities such that the character of income and gains realized by the hedge fund flows through to the fund's investors and is generally taxed at the investor level only.

An overview of the key tax considerations for each of the three types of structure is set out below. This overview assumes that the fund is not considered a Specified Investment Flow-Through (SIFT).

Trusts

A hedge fund that is structured as a trust is potentially subject to income tax, alternative minimum tax, penalty tax for investments that are not prescribed, and an additional tax.

A trust is taxed at the highest income tax rate applicable to individuals, which is approximately 50% for Ontario residents. If the trust is not a mutual fund trust, the trust may also be subject to alternative minimum tax (AMT), depending upon the types of income earned by the trust. In particular, AMT may arise where the fund has expenses and income losses in excess of the amount of capital gains realized in the year. AMT is a non-recoverable cost to the fund and hence should be avoided if possible. In most cases a hedge fund that is a trust will distribute sufficient income to investors such that the fund will not have any income tax or AMT payable. The amount that the trust must distribute will depend in part upon whether the fund is a mutual fund trust throughout the year. A mutual fund trust is a unit trust that meets additional criteria. The requirements for attaining unit trust status and mutual fund trust status are summarized below.

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Many hedge funds are set up as trusts so that they can be held by investors in registered plans (such as Registered Retirement Savings Plans (RRSPs)) and Tax Free Savings Accounts (TFSAs). A trust that is a registered investment (described below) is also subject to a monthly 1% penalty tax on the fair market value of any investments owned by the trust that are not prescribed.

A unit trust that is not a mutual fund trust may also be subject to a tax under Part XII.2 of the Income Tax Act (Canada) (the Act) where the trust makes certain Canadian source income payable to non-resident beneficiaries or to certain Canadian tax-exempts.

Unit Trust

To qualify as a unit trust, the trust must be an *inter vivos* trust and the interest of each beneficiary in the trust must be described by reference to units of the trust. In addition, the trust must meet all the conditions within one of the following two tests:

1) The 'surrender on demand test': whereby at least 95% of the fair market value of all the issued units of the trust must be attributable to units of the trust that are redeemable at the demand of the holder; or
2) The 'property holdings' test: whereby the trust was resident in Canada throughout the year and each of the following investment restrictions are met:
   a) throughout the year at least 80% of the trust's property consisted of shares, any property that is convertible or exchangeable for shares, cash, bonds, debentures, mortgages, marketable securities, real property situated in Canada, rights to and interests in any rental or royalty computed by reference to the amount or value of production from Canadian petroleum, natural gas, or mineral resources;
   b) the trust derived at least 95% of its income for the year from, or from the disposition of, the investments described above; and
   c) throughout the year, not more than 10% of the trust's property was bonds, securities or shares in any one corporation or debtor other than a Canadian federal, provincial or municipal entity.

Unit trusts that qualify under the 'surrender on demand' test are typically referred to as 'open ended' Such trusts generally have more flexibility to make investments. Trusts that qualify under the 'property holdings' test are generally referred to as 'closed ended' The investment strategy and type of fund will impact which of the two types of unit trust should be pursued. For example, open ended funds may not be suitable if the investment manager does not want to have to sell investments in order to fund redemptions.

Mutual Fund Trust

If additional criteria are met, a unit trust may also qualify as a mutual fund trust. Mutual fund trust status is advantageous for a number of reasons, including the following:

- investments in a mutual fund trust are qualified investments for registered plans;
- mutual fund trusts are not subject to alternative minimum tax;
- mutual fund trusts can claim a refund of some of the tax payable on realized capital gains and hence less income needs to be distributed to investors in order for the fund not to pay tax.

by Carmela Pallotto, KPMG LLP and Daniel Tworzewski, KPMG LLP

Technically, a mutual fund trust is subject to tax on its taxable income. In most cases, however, a mutual fund trust either distributes all of its income for income tax purposes to its unit holders, thereby eliminating its taxable income, or retains enough taxable income after distributions so that the tax on that taxable income and the capital gains refund mechanism result in no taxes payable at the mutual fund trust level. Only a trust that qualifies as a mutual fund trust throughout the taxation year is entitled to the capital gains refund. Without the capital gains refund mechanism, it is possible that the same gain would be taxed twice: once when the investor redeems of units in the fund at a price that reflects the accrued gains in the fund, and then again when the fund sells the investments that have accrued gains in order to fund the redemption. Taxes paid on realized capital gains are generally refundable to a mutual fund trust based on a formula which takes into account the redemption of units in the year, and realized and unrealized capital gains.

By filing an election with the tax authorities, a mutual fund trust, other than a money market fund, can choose 15 December as its taxation year-end rather than 31 December. If a 15 December year-end is chosen, distributions by a mutual fund trust to unit holders after the 15 December year-end, but on or before 31 December, are deemed to have been paid in the preceding taxation year. This treatment provides the mutual fund trust with more time to calculate and process the required amount of distributions to be made to ensure the mutual fund trust is not subject to tax.

To qualify as a mutual fund trust at any particular time, the trust must be a unit trust resident in Canada and all of the following conditions must be met:

1) The only activities of the trust must be investing in property (other than real property or an interest in real property); acquiring, holding, maintaining, improving, leasing or managing any real property, or an interest in real property; or any combination of these two activities;
2) Either a class of units of the trust must be 'qualified for distribution to the public' or there has been a lawful distribution in a province to the public of units of the trust and a prospectus or registration statement was not required to be filed in connection with the distribution; and
3) There are at least 150 beneficiaries of the trust holding any one class of units described above in (2), each such beneficiary holds at least one 'block' of units, and the fair market value of these units is at least $500. The number of units in a block depends on the fair market value of one unit as set out in the table below:

Fair Market Value of One Unit	Number of Units in a Block
< $25	100
$25 to < $100	25
$100 or more	10

Where a newly-formed unit trust meets all of the conditions listed above before the 91st day after the end of its first taxation year, the trust can file an election to be deemed to be a mutual fund trust from the beginning of its first taxation year. This will enable the trust to take advantage of the refundable capital gains mechanism in its first taxation year and reduce the double tax that would otherwise result.

Notwithstanding that a unit trust may otherwise qualify as a mutual fund trust, the trust may be deemed not to be a mutual fund trust if it can reasonably be concluded that the trust was established or maintained primarily for the benefit of non-residents. There are two exceptions to this deeming rule. The first exception applies if the trust does not hold taxable Canadian property in excess of a specified threshold. The second exception applies if the trust has not issued any units (other than in certain circumstances) to a non-resident. Several years ago, changes were proposed to this deeming rule and the exceptions. However, it is not known whether the changes will be enacted as proposed.

Corporations

Flowing income other than capital gains and Canadian dividends through a corporation without tax at the corporate level is difficult. Accordingly, not many hedge funds are structured as corporations. Those that are structured as corporations are usually structured as mutual fund corporations in order to utilize the refundable capital gains tax mechanism to reduce some of the double tax that would otherwise result. Mutual fund corporations can also be structured as 'switch' or 'corporate class' funds such that different strategies are offered via different classes of shares and investors can 'switch' between strategies and classes on a tax-deferred basis.

To the extent that a mutual fund corporation pays capital gains dividends in a defined period and/or there are capital gains redemptions, the mutual fund corporation is generally entitled to claim a refund of some of the corporate taxes payable on such capital gains based on a formula that also takes into account realized and unrealized capital gains. This reduces the double tax that would otherwise arise. In order to qualify for the capital gains refund, the corporation must have been a mutual fund corporation throughout the taxation year.

Like all Canadian corporations, a mutual fund corporation may claim a deduction for taxable dividends received from taxable Canadian corporations. Mutual fund corporations must pay refundable Part IV tax at a rate of 33.3% on taxable dividends received from Canadian corporations. Provided that the mutual fund corporation is not an 'investment corporation' as defined for Canadian tax purposes, the mutual fund corporation will obtain a refund of the Part IV tax paid when the mutual fund corporation pays a taxable dividend to its shareholders.

Double tax can still arise if the mutual fund corporation earns foreign source income or investment income other than dividends from taxable Canadian corporations and capital gains. In addition, a mutual fund corporation is not entitled to the 13% general federal corporate income tax reduction. Accordingly, interest, foreign income, and ordinary income should not be earned in a mutual fund corporation unless there are sufficient expenses in the fund to offset such income.

A hedge fund that is structured as a corporation may be held by investors in registered plans and TFSAs if it is a mutual fund corporation, or if it has applied for, and received, registered investment status. A corporation that is a registered investment is also subject to a monthly 1% penalty tax on the fair market value of any investments owned by the corporation that are not prescribed.

by Carmela Pallotto, KPMG LLP and Daniel Tworzewski, KPMG LLP

Mutual Fund Corporation

To qualify as a mutual fund corporation, the following conditions must be met:

1) the corporation is a public corporation incorporated and resident in Canada;
2) the corporation's only activities are investing in property (other than real property); acquiring, holding, maintaining, improving, leasing or managing any real property; or any combination of these two activities; and,
3) at least 95% of the fair market value of all the issued shares of the corporation must be redeemable at the demand of the holder.

In order to be a public corporation, the corporation must be resident in Canada and have a class of shares of its capital stock listed on a designated stock exchange in Canada. Alternatively, the corporation may file an election to be treated as a public corporation if all of the following conditions are satisfied at the time the election is filed:

1) a class of shares of the corporation is qualified for distribution to the public;
2) there are at least 150 shareholders of that class of shares, other than insiders of the corporation, owning at least one block of shares of the class. If those shares are not equity shares, there must be 300 shareholders of that class, other than insiders, owning at least one block of shares;
3) each shareholder owns shares of that class having a fair market value of at least $500; and
4) insiders of the corporation do not hold more than 80% of the issued and outstanding shares of that class.

For these purposes, the term 'block' has the same meaning as it has in the context of a mutual fund trust (see above). Where the election is filed with the corporation's tax return for its first taxation year, the corporation may also elect to be deemed to have been a public corporation from the beginning of the year. This is necessary so that the corporation can take advantage of the refundable capital gains mechanism for its first taxation year.

Notwithstanding that a corporation may otherwise qualify as a mutual fund corporation, the corporation may be deemed not to be a mutual fund corporation after a particular time if it can reasonably be concluded that the corporation was established or maintained primarily for the benefit of non-residents. There are two exceptions to this deeming rule. These exceptions are similar to those described above for the similar deeming rule that applies to mutual fund trusts. Several years ago, changes were proposed to this deeming rule and the exceptions. However, it is not known whether the changes will be enacted as proposed.

Limited Partnerships

Where a hedge fund is structured as a limited partnership, the investment manager typically forms a corporation to act as the general partner and investors subscribe for limited partnership units in the fund.

For Canadian tax purposes, a partnership is generally not a separate taxable entity. However, the partnership must compute its taxable income as if it were a separate person. Any taxable income or losses computed at the partnership level are allocated to the partners and taxed at the partner level, even if the income is not distributed to them. Hence there is never a risk of taxation at the fund level.

Generally, a partnership that has at least one partner that is an individual or a trust must have a 31 December taxation year-end.

by Carmela Pallotto, KPMG LLP and Daniel Tworzewski, KPMG LLP

Indirect Taxes

Investment funds must generally pay the Goods and Services Tax (GST) or Harmonized Sales Tax (HST) and the Quebec Sales Tax (QST), if applicable, on their taxable purchases including fees charged by the fund manager.

The tax charged by qualifying fund managers to qualifying investment funds is calculated by using rates known in the industry as the 'blended rates' which generally are based on various factors. Effectively, the blended rate is the net amount of the GST/HST and QST charged by the manager to the investment fund and the refund or the tax owing by the investment fund based on a formula. This formula takes into account the place of supply rules, the value of the units held by investors in each jurisdiction, the applicable GST/HST and QST rate, as well as recent indirect tax changes. In such a case, the manager accounts for tax, for example when calculating the tax on the daily management fee accrual, using the blended rate rather than charging the GST/HST and QST to the fund and the fund claiming a refund or paying at a later date additional tax based on the results of the formula.

The blended rate is generally determined by using investor data as of 30 September. In order to take advantage of the blended rate, the investment fund and the manager are required to make certain administrative elections.

Fees charged to partnerships by managers will generally be subject to GST/HST and possibly QST based on the business address of the partnership (which may be the location of the general partner) and the applicable GST/HST rate in that jurisdiction. Other rules may apply. If the manager does not receive a fee but instead receives a share of the profits for the manager's activities as a partner, the profit received by the manager may not attract GST/HST, depending on the facts and circumstances of the parties.

Taxation of the Fund's Activities

Gains/Losses

For Canadian tax purposes, only 50% of capital gains (referred to as 'taxable capital gains') are included in net income for tax purposes. Taxable capital gains can be offset by 50% of capital losses realized in the current year, prior years, or in the three subsequent taxation years. In contrast, gains that are on income account are fully taxable and losses that are on income account are fully deductible in most cases. Hence, taxable investors will prefer earning capital gains rather than ordinary income.

Whether a particular gain or loss is on account of capital or income depends on the facts and circumstances of the situation and the intentions of the fund. Generally an investment will be considered to be held on capital account if it produces income (eg. interest, dividends) while it is held. For some hedge funds, gains and losses will be on income account unless the fund has made an election (commonly referred to as a '39(4) election') as described below.

Disposition of 'Canadian Securities'

In some instances, the fund may elect under Subsection 39(4) of the Act to treat all gains and losses from dispositions of 'Canadian securities' as on capital account. Once the 39(4) election is made, it is effective for all future years and applies to short sales of 'Canadian securities' as well. In effect, a fund is able to ensure capital gains treatment on Canadian securities by filing this election. Hedge funds that are structured as mutual fund trusts or mutual fund corporations may make this election. Other trusts and corporations cannot make the election if they are considered a trader or dealer in securities or if they meet certain other conditions. Hedge funds that are structured as partnerships cannot make the election, but the partners in the fund (other than other partnerships) can make the election on their own behalf.

Canadian securities generally include: shares of a Canadian resident corporation; units of a mutual fund trust; and bonds, debentures, notes, mortgages and similar obligations issued by a Canadian resident person. There are, however, a number of exclusions from the definition of 'Canadian security'. In particular, shares of certain private corporations and derivatives.

Suspended Losses

Where a hedge fund sells an investment to trigger a capital loss and the hedge fund acquires an identical investment within 30 days before or after the sale, the loss on the disposition is not recognized for tax purposes. The loss is 'suspended' and can only be claimed by the hedge fund when the investment is no longer held. Where not all the shares or units of a particular investment are sold, part of the loss is denied and allocated to the shares/units still held. This rule may be problematic for fund of funds structures.

Stop-loss Rules

Where a fund has realized a loss on the disposition of shares and the fund also received dividends on those shares prior to the disposition, the stop-loss rules may apply to reduce the amount of the loss that the fund can claim. The rules vary slightly depending upon whether the fund is a partnership, trust, or corporation and depending upon whether the shares were held on account of capital or on account of income. In general terms, the loss will be reduced by the amount of 'tax-free' dividends received on the shares unless the fund did not own more than 5% of the issued shares of any class and the fund held the shares for at least 365 days.

Short Sales and Derivatives

Income from short sales and derivatives is generally considered to be on income account. However, the tax authorities have stated that where a short sale or derivative is entered into in order to hedge a property that is held on account of capital, the gain or loss on the short sale may also be on account of capital provided that there is sufficient linkage between the short or derivative and the hedged item. As noted above, short sales of Canadian securities will be on capital account if the fund has filed an election.

New rules were introduced in the 2013 federal budget that result in gains and losses on certain transactions using derivatives, referred to as character conversion transactions, being treated on income account. A character conversion transaction generally involves a derivative forward agreement (DFA) to buy or sell a capital property at a specified future date and that has a term, either alone or as part of a series, greater than 180 days. The purchase or sale price of the capital property under the DFA is not based on the performance of the capital property between the date of the agreement and the future date, but rather is based on the performance of a different property. The income (or loss) on a DFA is included (or deductible) in computing income (not capital gains) at the time of disposition if the capital property is subject to a derivative forward sale agreement and at the time of acquisition if the capital property is subject to a derivative forward purchase agreement.

by Carmela Pallotto, KPMG LLP and Daniel Tworzewski, KPMG LLP

These new provisions apply to agreements and arrangements entered into on or after 21 March 2013. However, they also apply to agreements and arrangements entered into before 21 March 2013 if their term is extended on or after 21 March 2013. Grandfathering relief is available for acquisitions and dispositions of property that occur before 22 March 2018, subject to growth limits in the notional amount of the derivative contract. If the notional amount of the derivative forward contract at 20 March 2013 has grown by the amount greater than the growth limit, the forward agreements will no longer qualify for grandfathering.

Securities Lending

In order to cover a short position, a fund may 'borrow' the relevant securities. Where certain criteria are met, this transaction will be considered a securities lending arrangement for income tax purposes and the tax treatment of the transaction will be determined based on specific rules in the tax legislation.

Where a fund has borrowed or received a qualified security under a securities lending arrangement, the fund will make compensation payments if there is a distribution on the underlying security. Where the compensation payment is in respect of Canadian dividends, the fund will generally not be permitted to deduct the payment when computing net income for tax purposes. However, if the fund is structured as a trust the fund may be able to net the short dividend payment against dividends received. Where the compensation payment is not in respect of Canadian dividends, the treatment of the compensation payment will depend, in part, upon whether the fund has disposed of the borrowed securities, and on whether the fund has included any amounts in income.

Loss Restriction Events

Certain investment funds that are trusts may be affected by a measure in the 2013 federal budget that extended the tax loss restriction rules to trusts. While it does not appear that these new rules were intended to catch regular course investments and redemptions related to investment funds, investment funds are not exempt from the application of the new rules.

Generally, a loss restriction event will occur when a person or a group of persons acquires more than 50% of the fair market value of the income or capital interests in a trust. If a loss restriction event occurs, a hedge fund trust may be subject to various tax consequences including a deemed year end, realization for tax purposes of accrued losses, expiry of loss carry forwards, and limitations on the carry back of losses realized after the loss restriction event has occurred. These rules could be particularly problematic for fund-on-fund structures, pooled funds, newly-formed funds, and funds that are being wound up or merged. The investment fund industry has outlined its concerns to the Department of Finance and it is hoped that relief will be granted (at the time of writing this editorial, relief has not been received).

by Carmela Pallotto, KPMG LLP and Daniel Tworzewski, KPMG LLP

Offshore Investments

A hedge fund that invests in non-Canadian investment funds must consider the offshore investment fund property rules. These rules apply if one of the main reasons for the investment is to reduce or defer the tax liability that would have applied to the income generated by the underlying assets of the offshore fund if such income had been earned directly by the Canadian hedge fund. If the rules apply, the Canadian hedge fund is required to include in income an annual return based on the designated cost of the investment and a prescribed rate of return.

Access to Tax Treaties

A fund that has invested in securities issued by non-residents may pay foreign tax on any income received on the investment. Typically, the foreign tax is withheld at source and the fund receives the income net of the foreign tax. Canada currently has 92 double tax agreements signed and in force. These tax treaties will typically reduce the rate of foreign tax applicable. For example, under most of Canada's treaties the foreign tax rate on interest is reduced to 10% or 15%. In addition, most treaties will exempt gains on certain types of property from tax in the foreign country. A hedge fund may be able to submit a claim to obtain a refund of any excess tax that has been withheld.

A double tax treaty should generally prevent or relieve double taxation for hedge funds structured as corporations. When applying double tax treaties to trusts or partnerships, it is critical to carefully review and interpret the relevant treaty provisions as the treatment may differ from treaty to treaty. For example, in the Canada-UK tax treaty, a 'person' means an individual, trust, corporation and any taxable entity, but not a partnership, whereas in the Canada-Spain treaty, a 'person' includes a partnership. Consequently, a fund structured as a trust or partnership may not always be able to rely on a treaty for relief.

Summary

The table below provides a summary of the unique features of different fund vehicles.

	Unit Trust	**Mutual Fund Trust**	**Mutual Fund Corporation**	**Limited Partnership**
Subject to income tax	Yes	Yes	Yes	No
Subject to alternative minimum tax	Yes	No	No	No
Tax can be eliminated if sufficient distributions made	Usually	Yes	Usually	N/A
Tax on investments that are not 'prescribed'	Yes, if fund is a registered investment	Yes, if fund is a registered investment	Yes, if fund is a registered investment	N/A
Subject to Part XII.2 tax	Yes	No	No	No
Taxation year end	31 December 31	15 or 31 December	Any time	31 December unless only corporate partners
Can file a 39(4) election for capital gains on Canadian securities	Yes, if qualify	Yes	Yes	No. Filed at partner level
Restrictions on activities/ investments	Yes	Yes	Yes	N/A
Units/Shares must be redeemable	Yes, unless closed ended	Yes, unless closed ended	Yes	No
Minimum number of investors required	No	Yes	Yes	No

by Carmela Pallotto, Partner, KPMG LLP and Daniel Tworzewski, Partner, KPMG LLP

Taxation of Canadian Resident Investors

This summary assumes the hedge fund is held as capital property by a Canadian resident taxpayer that is not a financial institution.

Distributions and Allocations

Generally, taxable Canadian resident investors in hedge funds are subject to tax on the income earned by the hedge fund and distributed to them in cash or in kind, as well as on any gain arising on disposition of the hedge fund investment. Taxable dividends from taxable Canadian corporations, capital gains, and foreign source income earned by a hedge fund trust retain their character in the hands of Canadian resident investors for tax purposes to the extent that the hedge fund trust makes a designation. Effectively, such income is taxed at the investor level as if the investor had earned the income directly. The same result arises automatically for investors in limited partnerships ie, the partnership does not have to make any designations. In contrast, only capital gains earned by a mutual fund corporation and distributed as capital gains dividends retain their nature in the hands of Canadian resident investors. All other types of income earned and distributed by a mutual fund corporation are taxed as Canadian dividends in the hands of investors.

It is important to note that an investor in a hedge fund that is structured as a limited partnership must include in income the portion of the hedge fund's taxable income that has been allocated to the investor, even though, in most cases, the limited partnership will not make any distributions to the investor. This may result in cash flow issues for investors.

Tax-deferred Plans and TFSAs

Individuals who wish to hold their hedge fund investment in a tax-deferred plan, such as an RRSP or in a TFSA, should ensure that the hedge fund is considered a qualified investment in order to avoid penalties and taxes that can be significant. Units in a mutual fund trust and shares in a mutual fund corporation are qualified investments. Trusts and corporations that are not mutual funds may apply to the Canada Revenue Agency to become registered investments that can be held by registered plans and TFSAs. Such funds are often referred to as 'quasi mutual funds' and are subject to strict investment restrictions. It is possible for a limited partnership to qualify as an investment for tax-deferred plans if, among other conditions, the limited partnership units are listed on a prescribed stock exchange. In our experience, very few hedge fund partnerships pursue stock exchange listings.

Individuals should also ensure that any investments they hold in a registered plan are not considered 'prohibited investments' as the penalties for holding a prohibited investment are harsh. When purchasing shares, trust units, or partnership units for their registered plan or TFSA, an investor must take care to ensure that the investments do not result in the investor owning 10% or more of the value of the corporation, trust, or partnership either alone, or together with related parties. It is therefore important to also understand investments held by a spouse, children, or other related persons. A debt or share of, or an interest in, a corporation, trust or partnership with which the RRSP, RRIF, or TFSA holder does not deal at arm's length may also be prohibited.

by Carmela Pallotto, KPMG LLP and Daniel Tworzewski, KPMG LLP

Flow Through of Losses and Expenses

Generally, an investor in a hedge fund structured as a limited partnership is taxed as if the investor had earned the income directly. Where the hedge fund has realized losses other than capital losses, the investor may deduct such losses to the extent of the investor's 'at-risk amount'. The amount of such losses over the at-risk amount can be carried forward and generally deducted in a future year to the extent of the at-risk amount in that year. Capital losses realized by the fund are claimable at the investor level to the extent that the investor has capital gains in any of the preceding three years, the current year, or a future year.

A partnership that invests in mining and resource companies may also flow through to its investors various resource expenditures (such as Canadian Exploration Expense) that have been incurred by the mining or resource companies and renounced to the partnership. This enables the investor in the fund to claim deductions for these amounts. Consequently, many resource funds are structured as partnerships and within a couple of years, the assets and investors are transferred to a mutual fund corporation through a series of transactions that provides the investors with liquidity.

Summary

The table below provides a summary of the taxation of Canadian resident investors.

	Unit Trust	**Mutual Fund Trust**	**Mutual Fund Corporation**	**Limited Partnership**
Investor is taxed on	Distributions received	Distributions received	Distributions received	Share of fund's taxable income
Distribution taxed in investor's hands as if investor earned directly	Yes	Yes	Capital gains only. All other income taxed as a dividend.	Yes
Investor can deduct fund's losses	No	No	No	Yes, subject to at-risk rules
Eligible investment for tax-deferred plans and TFSAs	If 'registered'	Yes	Yes	Rarely

by Carmela Pallotto, KPMG LLP and Daniel Tworzewski, KPMG LLP

Taxation of the Fund Manager

This summary assumes that the hedge fund manager is a taxable Canadian corporation and is not a financial institution.

There is no special tax regime applying specifically to fund managers. Management fees earned by fund managers are generally taxed as ordinary business income. If the fund manager of a limited partnership receives an allocation of partnership income, the character of the income earned by the partnership will generally flow through to the manager, depending upon the facts and circumstances.

The fund manager is taxed at the regular combined federal and provincial rate, which amounts to approximately 26.5% for a corporation assuming that it operates in Ontario. If the fund manager is a Canadian-controlled private corporation, eligible active business income earned in Canada (generally to a maximum of $500,000) is taxed at rates, for example, 15.5% if the fund manager operates in Ontario. Provincial tax incentives may be available to fund managers that carry on qualifying international financial activities in the province of British Columbia, or in the city of Montréal within the province of Québec.

For indirect tax purposes, the supply of management and administrative services by a fund manager to a hedge fund is generally subject to GST or HST and may be subject to QST. The calculation of tax will depend on how the fund is structured, in particular, whether or not the fund is structured as a partnership. For many investment funds the tax will be calculated by using the blended rates or will be based on the contracting location.

Fund managers may need to register for QST purposes as of 1 January 2013 to remit the QST component of the blended rates, or may need to remit the QST amounts as non-registrants.

A fund manager registered for GST/HST and QST purposes is generally permitted to claim credits for the GST/HST and QST paid on its purchases of goods and services to the extent the purchases are attributable to the making of GST/HST and QST taxable supplies.

Carmela Pallotto
Partner
KPMG LLP
carmelapallotto@kpmg.ca
Tel: 416.777.3618

Daniel Tworzewski
Partner
KPMG LLP
dtworzewski@kpmg.ca
Tel: 416.777.8498