HEDGE FUND MANAGERS: TIME FOR YOUR ANNUAL REGISTRATION CHECK-UP? QUICK TIPS ON DOING A SELF-DIAGNOSIS

Securities laws, anti-money laundering and terrorist financing reporting regulations have, over the past few years, gone through a significant overhaul in Canada. At the same time, regulatory oversight and compliance audits have increased.

The hedge fund industry is becoming increasingly regulated and all hedge fund managers need to stay on top of things. Now might be a good time to perform a self-diagnosis of your compliance regime. The following is not intended to be a complete review of all compliance matters applicable to managers of privately offered pooled funds, but is a reminder of some basic compliance issues and some simple fixes. Time-sensitive requirements should be diarized.

The Annual Check-up: National Instrument 31-103 Registration Requirements and Exemptions (NI 31-103) requires the firm’s Chief Compliance Officer (CCO) to submit an annual report to the firm’s board of directors for the purpose of assessing compliance by the firm, and individuals acting on its behalf, with securities legislation. For a one-man shop, the CCO and the “board of directors” may be one and the same. Whether you are preparing a report to the board, or a memo to file, your principal regulator’s compliance staff may ask for a copy when they conduct a compliance audit of your firm. A report that outlines the results of your review of a checklist of compliance matters can help satisfy this requirement.

Hedge fund managers that are registered as advisers or dealers under NI 31-103 are considered to be “securities dealers” for the purposes of the federal Proceeds of Crime (Money Laundering) and Terrorist Financing Act and must comply with regulations under that Act and the published guidelines of FINTRAC, the body that oversees the anti-money laundering (AML) regime in Canada. The firm must conduct a full compliance review of its AML policies and procedures to test their effectiveness at least once every two years. Firms that do not have dedicated personnel or an independent firm engaged for this purpose can do a “self-review”. If feasible, this self-review should be conducted by an individual who is independent of the reporting, record-keeping and compliance-
monitoring functions. Firms are not required, but may wish, to engage an outside legal or accounting firm to conduct the review.

Where to start?: As CCO, you must make yourself familiar with NI 31-103 and should have a copy of the most current version on hand. Pay particular attention to Parts 11 to 14, which deal with business operations and client relationships, and don’t forget the Companion Policy attached to NI 31-103. The Ontario Securities Commission website (www.osc.gov.on.ca) and the websites of any other securities commissions with which your firm is registered should be consulted often for current regulatory and compliance developments.

For AML compliance, you should also read the FINTRAC guidelines (www.fintrac-cafeg.gc.ca/publications/guide/guide-eng.asp) that apply to you as a “securities dealer”.

Learn From Others’ Mistakes: A great way to get a handle on where to start is to see where others have gone wrong. Compliance and Registrant Regulation staff at the OSC prepare regular reports on the results of their regulatory compliance audits; the latest was published on October 15, 2010 (OSC Staff Notice 33-734). This Advisory will discuss some but not all of the common deficiencies identified by OSC staff. Other regulators, such as the British Columbia Securities Commission, also publish reports.

Common Deficiencies: Addressing the common deficiencies should be the first step in any self-diagnosis. OSC Staff Notice 33-734 identified key areas of non-compliance among investment fund managers, portfolio managers and exempt market dealers:

- Marketing
  - Inadequate disclosure relating to performance data
- Exaggerated or unsubstantiated claims
- Inappropriate use of benchmarks
- Improper marketing of performance returns from a previous firm
- Suitability, KYC and KYP
- Written policies and procedures and compliance systems
- Risk management
- Use of side letters
- Inadequate disclosure to clients
- Prohibited investments for investment funds

Some of these deficiencies were likely exacerbated by the transition to the NI 31-103 regime, as some firms were slow to respond to the changes. The Staff Notice offers “suggested practices” which you should consider. You may wish to work with your legal counsel or other compliance advisers to adopt and implement practices that are appropriate for your firm.

Registration: Although not noted as a common deficiency in OSC Staff Notice 33-734, failure to register your firm and individuals within the firm in all required categories and in all applicable jurisdictions can have the most serious consequences. Have you discussed with your compliance advisers where your firm needs to be registered and in what categories, and which individuals within the firm require registration? Firms that are relying on the transitional investment fund manager and exempt market dealer registration exemptions because they filed their applications by the September 28, 2010 deadline need not worry if they have not yet heard back from the regulators on their transitional application – the regulators are still dealing with a huge backlog of applications. Note that the provisions of NI 31-103 that apply to registered investment fund managers (such as quarterly
financial statement filings) do not apply to your firm until it is registered as an investment fund manager.

**Notice of Change:** Have you moved offices recently? Has one of your officers resigned or changed residential addresses? One frequently occurring deficiency, that can result in significant late filing fees for a registrant, is the failure to notify the principal regulator that there has been a change in the information previously provided on the Form 33-109F6 for the firm, or the Form 33-109F4 for an individual. Most changes must be reported within 7 calendar days.

**Marketing:** At the time of publication of this Bulletin, the OSC is conducting a “sweep” to assess the marketing practices of registrant firms. A sweep is a targeted compliance audit, and this particular sweep is a direct response to the ranking of marketing as the number one significant deficiency identified in OSC compliance audits in 2009. There are no published guidelines as to what marketing practices are permitted in the exempt market, although in 2007 the OSC published a staff notice dealing with marketing practices of portfolio managers. A registered firm is required to “deal fairly, honestly and in good faith with its clients”. Performance data must be clear (e.g. described as net or gross of fees) and material differences between fund returns and benchmark returns must be disclosed (e.g. use of leverage or short positions, and concentrated versus broad portfolio holdings; are all relevant). Claims must not be exaggerated, such as “proven performance, superior to index returns” or “best in class”, where they cannot be supported by actual performance numbers. Performance returns from a previous firm must not be used when the advising representative was not responsible for generating present returns or the investment strategy at the previous firm was different from that of the new firm.

**Regulatory Capital:** How’s your regulatory capital? When was the last time you checked? Does your firm meet the working capital requirements under NI 31-103 (as calculated using Form 31-103F1 Calculation of Excess Working Capital) for investment fund managers? All registered firms are required to ensure that excess working capital is not less than zero for two consecutive days. If at any time the firm’s working capital is less than zero, it must be reported to the firm’s principal regulator immediately. You must file a copy of any subordination agreement the effect of which is to exclude an amount from your long-term related party debt (as calculated on Form 31-103F1 Calculation of Excess Working Capital). Before repaying any part of the subordinated loan or terminating the subordination agreement, you must provide your principal regulator with five days’ prior written notice. Registrants cannot guarantee the debt of any other entity, including related companies, without impacting working capital.

**Regulatory Insurance:** Does your firm meet the insurance requirements under NI 31-103? Minimum insurance requirements increase with your firm assets or assets under management, and your coverage should be reviewed on a regular basis to ensure that it continues to meet the requirements of NI 31-103. Your board of directors should review and approve the insurance coverage at least annually.

**Know-Your-Client (KYC), Suitability and Disclosure to Clients:** NI 31-103 requires all registered firms to “know-your-client” and to do a suitability assessment before advising or conducting a trade on behalf of a client. If you wish to avail yourself of the “permitted client” exemption in this regard, make sure you fully
understand when it is available and from what practices you are exempt. Dealer firms must also know their product (KYP) before they can properly assess suitability – as a hedge fund manager you may find yourself spending more time educating your distribution network about the features of your hedge fund product. If you sell your fund through an agent, make sure that they are registered and conducting KYC in accordance with NI 31-103, otherwise that obligation falls on you. If you have legacy files that do not have a written record of KYC information, ensure that KYC forms are completed and put into the file. Also ensure KYC information in all files is kept current – the frequency of your updates will depend very much on the nature of the client and the nature of the investment. Note that, as a registrant, your firm cannot delegate KYC and suitability obligations to other parties. Even if a client has been referred to you, you should still be conducting your own KYC and suitability assessment of the referred client. Make sure that all of your dealer and advisory clients have received a document (within or alongside the offering memorandum or subscription or managed account agreement) setting out your duties, your fees and the client’s investment mandate, and all other client disclosures required by NI 31-103.

**Side Letters:** Long the bane of fund managers, side letters have caught the attention of the regulators. In OSC Staff Notice 33-734, the OSC explained that staff have concerns with investment fund managers giving preferential treatment to one or more investors in the same class of units of an investment fund (for example, preferential portfolio transparency, redemption rights, fund reporting and fees), as this can disadvantage the other investors. As an alternative to side letters, and assuming a fund’s constating documents permit it, consider issuing a different class of units and disclosing the rights and terms of each such class in the fund’s offering document.

**Prohibited Investments:** Are you familiar with the investment restrictions set out in securities laws that may apply to your investment fund? For example, investment funds that meet the definition of a “mutual fund” in Ontario have specific prohibitions against investments in securities of their related parties, and investments in a person or company in which the mutual fund, alone or together with its related mutual funds, owns more than 20 percent of the outstanding voting securities. In addition, a portfolio manager is prohibited from causing an investment fund for which it acts as adviser from purchasing a security of an issuer in which a “responsible person” or an associate of a responsible person is a partner, officer or director unless this fact is disclosed to the client and the prior written consent of the client is obtained (note that disclosure should be provided to, and consent obtained from, each securityholder of the investment fund in order for it to be meaningful). Inter-fund trading between funds under common management is prohibited in the absence of exemptive relief.

**Client Complaints:** Are you aware of, and prepared for, the looming September 28, 2011 deadline for making available independent dispute resolution or mediation services to your clients to resolve client complaints? After September 28, 2011, if a person or company makes a complaint to you about any of your trading or advising activities, you must as soon as possible inform the person or company of how to contact and use the dispute resolution or mediation services which you offer (note, however, that if your firm obtained registration after September 28, 2009, you are already required to have in place independent dispute
resolution or mediation services). All registered firms are already required to document and respond to client complaints about products or services which you offer. Firms operating in Québec must comply with Québec regulations that apply (and have applied for some years) to complaints raised by residents of that province.

**Offering Memorandum:** When was the last time you updated your funds’ offering memorandum? Did you file it with any securities commission? Certain provinces, such as Ontario, require an offering memorandum to be filed within 10 days of the first closing of the sale of units or other securities in respect of which the offering memorandum was used (in Québec, the offering memorandum must be filed “without delay”). Each time the offering memorandum is updated, a new copy must be filed.

**Report of Trades:** Fund sales made under certain private placement exemptions (accredited investor and $150,000 exemptions, among others) must be reported to the securities commission in each province where sales were made either within 10 days of the closing of each new subscription or within 30 days after the fund’s financial year-end. The report must be filed on Form 45-106F1, although the BCSC has proposed a special BC-only form (we are monitoring this development). Fees are payable in most provinces.

**Financial Statements:** All registered firms must file with their principal regulator audited annual financial statements, together with a completed Form 31-103F1, within 90 days of their fiscal year end. Investment fund managers and dealers (other than exempt market dealers) must also file quarterly unaudited financial statements and a Form 31-103F1. Investment fund managers must include a description of any net asset value adjustments made during the year or quarter. For financial years beginning on or after January 1, 2011, all domestic registered firms must prepare their financial statements using IFRS.

All investment funds that are reporting issuers, and mutual funds that are not reporting issuers (other than those organized under the laws of certain provinces) are also required to make available to investors and file with the securities regulators annual audited financial statements (within 90 days of the year end) and six month interim unaudited financial statements (within 60 days). You may have to discuss with your legal advisers whether your fund is a “mutual fund” for securities law purposes. If its units or shares are redeemable on demand at net asset value, the fund probably is a mutual fund. Mutual funds are governed by National Instrument 81-106 Investment Fund Continuous Disclosure and, although exempt from many of the requirements of NI 81-106 if they are not reporting issuers, they must prepare the financial statements and make them available to their investors. If you do not want to have to file those statements with the applicable securities commission, you must prepare and file a one-time “Section 2.11 Notice” indicating your intention not to file. A similar note must go in the financial statements.

**Soft Dollar Arrangements:** All soft dollar arrangements must comply with National Instrument 23-102 Use of Client Brokerage Commissions, which came into force on June 30, 2010. 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.
**Referral Arrangements**: All referral arrangements must comply with NI 31-103. There must be a written agreement between the payor and 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.

**Trade Matching and Settlement**: National Instrument 24-101 *Institutional Trade Matching and Settlement* requires registered advisers whose clients use delivery-against-payment (DAP) or receipt-against-payment (RAP) accounts (primarily institutional clients whose securities are held by a custodian) to:

- establish, maintain and enforce policies in accordance with NI 24-101
- enter into a trade-matching agreement or be provided a trade-matching statement and
- complete and deliver an exception report if they have failed to match the trade within the required time period during any quarter.

**Policies and Procedures Manual**: All of the above, and more, should be set out in or addressed in a written policies and procedures manual that has been developed for your own organization. Registered firms that were not required to file a policies and procedures manual when they applied for registration are nonetheless required to have one, and will be asked to provide the manual when their principal regulator conducts a compliance audit. Off-the-shelf compliance manuals should only be used as a good head start and not as the beginning and the end of the development process. As important as the manual is, proper implementation is even more important to compliance staff, and you must be prepared to produce written documentation evidencing that implementation – failure to comply with your own written policies and procedures can constitute a “significant deficiency”.

Compliance is an ongoing and evolving process. NI 31-103 has placed significant emphasis on prudent business practice and the need for a registered firm to build a culture of compliance. Our bottom line? Be ready for that call from your principal securities regulator to say they are coming to pay you a visit. Nothing can take the place of good preparation and compliance practices, even when you are focused on enhancing the wealth of your clients.

If you would like more information about the compliance obligations and regulatory expectations of hedge fund managers, please contact the authors of this Bulletin, your usual lawyer in BLG’s Investment Management Group or any of the following leaders of our practice group.

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BLG’s Focus on Compliance

This Investment Management Bulletin was written in conjunction with Session 1 – Focus on Hedge Funds – the first breakfast session in BLG’s 2011 Investment Management Breakfast Series. Session 1 was held in Toronto on March 1, 2011, in Vancouver on April 5, 2011 and in Montréal on April 14, 2011.

Our more detailed newsletters on NI 31-103 and other regulatory developments will help you keep a focus on compliance during 2011. All of our newsletters are available on our website at blg.com and you may also access them through the following links:


**National Instrument 31-103 – At a Glance** August 2009.


**The Canadian Registration Regime: Canadian Regulators Propose “First Year” Amendments to National Instrument 31-103 and Other Developments** August 2010.

**Canadian Securities Regulators Propose Registration for Non-Resident Investment Fund Managers** November 2010.

**What’s Ahead? At a Glance Key Developments in Canadian Securities Regulation for the Investment Management Industry** Fall 2010.

**Focus on Compliance – What’s Important for 2011?** February 2011.
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