



Guide to Sound Practices for Canadian Hedge Fund Managers

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Foreword

The Canadian Hedge Fund market has witnessed rapid growth over the past three years. As a response to this growth, The Alternative Investment Management Association (AIMA) established a Canadian chapter in March of 2003 that now boasts over 50 corporate members. AIMA Canada is part of the global “non profit” association based in London, UK with over 600 corporate members worldwide. AIMA’s primary objectives are to increase investor education, transparency and promote due diligence as well as to work closely with regulators to better promote and monitor the use of alternative investments. With rapid global growth of the hedge fund industry, the need for Hedge Fund managers and their service providers to provide sound professional services as well as increased transparency has never been greater.

On August 30, 2002, AIMA, in conjunction with leading European industry participants released the “*Guide to Sound Practices for European Hedge Fund Managers*” (the “European Guide”) which has proved enormously popular. Given its success, a Canadian version of the European Guide (the “Guide”) has now been prepared. The Guide provides an overview of the many issues that should be considered by a Hedge Fund manager who manages funds in Canada, but is not intended to set out definitive standards or an exhaustive list of requirements that could serve as a benchmark against which conduct should be assessed. There is no substitute for professional advice in managing a hedge fund business.

A number of individuals have extended considerable time and effort in preparing the European Guide and this Guide and their valuable input is acknowledged in Appendix 1 and 2. It is intended that this Guide will be reviewed on a regular basis so its value to the industry does not depreciate. To this end, comments should be sent to:

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Chairman, AIMA Canada
March 1, 2004

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Introduction

This Guide considers various practical aspects of establishing and managing a Hedge Fund business in Canada and suggests corresponding sound practices. It is intended to be a useful tool to a wide variety of Hedge Fund managers, notwithstanding differences in terms of investment strategies employed or personnel, capital resources or systems capabilities.

Specifically, the Guide covers the following key topics:

- i. creating and managing a Hedge Fund business;
- ii. the investment process and portfolio risk management;
- iii. portfolio administration and operational controls;
- iv. raising capital and investor relations;
- v. Hedge Fund structures and organisation; and
- vi. special considerations for creating and managing a Hedge Fund of Funds business.

While the intention has been to produce a resource for general use, it should not be assumed that one size fits all. The size, nature, jurisdiction of regulation and complexity of a particular Hedge Fund manager's operations and investment strategy may mean that some or all of the sound practices set out in the Guide are in fact inappropriate to the business of a particular Hedge Fund manager. Accordingly, the sound practices should not be regarded as definitive or "best" practices.

As a general resource, the Guide should not be regarded as a substitute for professional advice, which should still be obtained where appropriate. The Guide does not replace any applicable laws or regulations, which are likely to be more detailed than the sound practices described. To the extent that the Guide refers to legal or regulatory issues, this is based on the Canadian regime.

The content and format of each chapter is designed to maximize the Guide's use as a practical and user-friendly tool, rather than a textbook. The Guide can be obtained from the following web sites:

www.aima-canada.org

www.aima.org



1. Creating and Managing a Hedge Fund Business

Establishing a Hedge Fund management business involves creating and managing a viable business.

The principals of the Hedge Fund management business, as the proprietors and/or controllers of a financial services business, are responsible for all aspects of that business and should give due consideration to the business risks involved at the start and throughout the life of the business.

This chapter reviews the requisite management systems and controls internal to a Hedge Fund management business. It does not extend to portfolio management, or the interfaces with Hedge Funds or managed portfolios, each of which are addressed separately in subsequent chapters. Although Hedge Fund management businesses are typically small, they may manage very large amounts of assets, with the result that the consequences of actions or omissions by the manager may have a significant impact on investors and the wider investment community. For this reason, an attempt is made to emphasize below the importance of strong procedures and controls, segregation of duties (where possible), managing the business risks involved and the need for skilled and experienced personnel, whether or not on an employed or externally retained basis.

The issues discussed below are common to all financial services businesses; however, the following guidance is intended to reflect the application of sound practice in the areas discussed to a typical Hedge Fund management business.

1.1 Creating a Hedge Fund Management Business

Creating a Hedge Fund management business is no different from establishing any other business. However most Hedge Fund management businesses are small, at least at the outset, and unlike other small businesses, are supported by a number of service providers such as prime brokers, administrators, compliance consultants, systems providers, Hedge Fund consultants, accountants and lawyers. This allows a small number of personnel to easily access a wide skill base.

There are a number of considerations which the principals of the Hedge Fund management business need to address when setting up their business. These include:

- i. the business opportunity;
- ii. short, medium and long-term goals;
- iii. the legal and tax structure;
- iv. ownership and funding of the management entity;
- v. regulatory environment and requirements;
- vi. investment strategy and key features;
- vii. size and type of the target investor market and marketing strategy;
- viii. management team and staffing requirements;
- ix. service providers and professional advisers;
- x. systems and IT requirements;
- xi. risk assessment and sensitivity analysis; and
- xii. financial forecasts and critical milestones.

It is important to seek advice from competent and experienced professional advisers or consultants in some of these areas to reduce or eliminate the business risks involved in setting up a new business. For example, the structure and manner of operation of the management business should not only be tax efficient and flexible but should be cost effective and easy to implement.



Some principals find it useful to address these matters in a business plan. The business plan can then be used to ensure that investments in people, technology and infrastructure are appropriately aligned with each other and with the overall objectives of the business. Furthermore, each of these investment decisions should be made in light of the anticipated future development of the business, in order to ensure that the business retains the flexibility to develop within the parameters of its proposed plans. The business plan may also cover a number of longer-term issues relevant to the manner in which the business is established and run. These may include a strategy to grow the business, planned exit route for the founders or the introduction of other principals and shareholders. Equally any plan should recognize any upper limit to the capital which can be invested effectively in any particular investment strategy.

1.2 Managing a Business

In many cases the principals of a Hedge Fund management business are also controllers of a financial services business, with related responsibilities which are significantly wider than the areas of portfolio management that they may have historically focused upon. Some of those areas — management and controls, finance, compliance and employee issues — are discussed further below. Other areas such as risk management, product development, operations and marketing are addressed in the other chapters.

1.3 Management and Controls

Every Hedge Fund management business, whatever its size, should organize its internal affairs in a responsible manner, ensuring it has appropriate systems, procedures and controls designed to mitigate and manage the risks to which the business is subjected. This should be documented, but the extent of documentation will vary depending on the complexity of the business operations.

Management should implement a business risk management process to assess all the non-investment risks associated with the business, although the degree of formality of this process will vary widely dependent upon the size and complexity of the business. It may, for example, range from an informal process conducted at management meetings to, in the case of a larger firm, a formal and rigorous process. Management should ensure that any internal or monitoring exercise includes a review of the key risks. The risk management process would typically encompass:

- i. the identification of the key risks facing the business, across all areas, including risks such as reliance on key clients or investors, reliance on key staff and access to sufficient capital.
- ii. a formal risk assessment of the business should be carried out no less frequently than on an annual basis and approved by the directors or other governing body. This process should be documented (whether formally or informally).
- iii. the implementation of controls to mitigate those risks. For each risk, management should determine whether to accept the risk, avoid the risk, transfer it (e.g. through insurance) or seek to mitigate the risk through controls. Where this last choice is made, so far as possible, those controls should be embedded in normal business processes. A significant risk to be accepted will be reliance on an initial few investors and a small number of key staff.
- iv. the design of a monitoring process to ensure effectiveness of those controls.
- v. reporting on both the effectiveness of controls and the changing risk profile of the business.

Effective controls should ensure that any significant weaknesses are reported to senior management as soon as they are detected and remedied.

The key areas which such risk management systems would typically cover include, inter alia, investment (see Chapter 2), finance, compliance, systems, tax and personnel.



1.3.1 OUTSOURCING

Where key functions are outsourced, management must be satisfied as to the competency of the relevant service provider and should have a process in place to monitor and review work performed. Such a process may include initial consideration of a number of outsourced service providers against a set of agreed upon criteria prior to selection and on an ongoing basis:

- i. assessment of performance against contractual or agreed standards;
- ii. periodic performance review meetings; and
- iii. comparison of actual results against expected results.

1.3.2 ALLOCATION OF TASKS

It is good business practice to attempt to segregate, amongst different personnel, duties which may be regarded as incompatible with each other. Examples include initiating and approving investment and cash transactions and monitoring portfolio risk. However, this is often difficult to achieve in Hedge Fund management businesses with a limited number of employees. There are minimal steps which can be taken to help reduce the risks. These include ensuring that key transactions, particularly those related to cash, are approved by two personnel and using the control systems and procedures of service providers to verify and oversee transactions.

1.4 Finance

1.4.1 SYSTEMS AND ACCOUNTING RECORDS

Firms should ensure that they have appropriate systems and procedures capable of:

- i. developing relevant budgets;
- ii. monitoring their financial resources position;
- iii. producing timely and accurate management accounting and financial information; and
- iv. providing necessary regulatory and statutory financial reports in the format that the jurisdiction requires.

In the case of (i), budgets should be prepared annually and updated where significant changes occur in underlying assumptions. They should include monthly income, expenditure and financial resources forecasts.

Procedures in respect of the processes adopted for each of (i) to (iv) above should be documented and retained.

1.4.2 FINANCIAL RESOURCES

Management should have the appropriate knowledge and skills to monitor the financial resources position of the business and to complete relevant regulatory financial filings. Canadian securities laws impose minimum capital requirements on Hedge Fund managers, registered as advisors and/or dealers, of a prescribed amount together with the deductible on mandated bonding or insurance. These laws will dictate the manner of computing financial resources for these purposes. Where possible, a Hedge Fund manager should be capitalized so as to meet the minimum requirements and should have some contingency to take account of expected future developments.



1.5 Compliance

Typically a Hedge Fund manager will need to have its business authorised or licensed by a local regulatory body. In Canada, registration with the applicable provincial and territorial securities regulators is required if the Hedge Fund manager will act as an advisor and/or dealer in the applicable jurisdiction, unless an exemption from registration is available. This can be a time-consuming and complex process; obtaining and retaining the correct authorizations for the business the Hedge Fund manager intends to operate is essential. Unless the Hedge Fund manager has the required in-house experience, professional advice should be sought to guide the manager through the initial registration process.

The Hedge Fund manager should also ensure that if any new business activity is planned, the compliance and internal resource requirements are understood and are in place prior to commencing such business.

A Hedge Fund manager should ensure it takes reasonable steps to understand the regulatory environment within which it operates and the specific rules applicable to its business. The Hedge Fund manager should develop procedures to comply with these rules. The Hedge Fund manager should additionally ensure that all staff are fully aware of the rules applicable to their particular area of work.

1.5.1 COMPLIANCE FUNCTION

The Hedge Fund manager should appoint a senior individual to take responsibility for compliance oversight. The Hedge Fund manager should ensure that this individual has the required proficiency and has sufficient time to dedicate to the task and that recurring tasks, such as record keeping and compliance monitoring, are completed on a timely basis. He or she should be vested with the necessary authority to enforce compliance with relevant rules and internal procedures.

It is unusual in smaller managers for the compliance officer to be full time or have total knowledge of all applicable rules and regulations. Where this is the case, the Hedge Fund manager should consider having an arrangement with appropriate professional advisers for further advice and guidance. The compliance officer and chief executive must be involved in key compliance issues and should ensure that they provide an appropriate compliance culture in the business.

1.5.2 COMPLIANCE MONITORING

The Hedge Fund manager should implement arrangements for the regular monitoring of business risks and for adherence to all compliance requirements. The frequency and scope of monitoring should be determined by the size and complexity of the business. Typically, a Hedge Fund manager would conduct a formal monitoring exercise on at least an annual basis which may be split into monthly or quarterly elements. Some aspects of the business may require more frequent monitoring in order to comply with the applicable regulatory requirements. The results of monitoring should be documented and communicated to management. Procedures should be in place to ensure that where weaknesses have been identified, these are promptly resolved.

1.5.3 RELATIONSHIP WITH REGULATOR

Where the investment business is regulated, managers should seek to retain an open and co-operative dialogue with their regulator.



1.6 Employees

1.6.1 INTRODUCTION

Typically, Hedge Fund managers employ small teams of specialized professionals who are highly committed and who are known to each other. Nonetheless, management should be committed to ensuring that employees:

- i. have the requisite level of knowledge and experience for the tasks they are undertaking;
- ii. are and remain competent for the work they undertake; and
- iii. are appropriately supervised and are regularly reviewed for their competence.

Senior management should be aware of the dependence which can be placed upon key individuals in a small team and seek to mitigate the risks involved if one of these key individuals leaves the Hedge Fund manager. Although not mandatory, Hedge Fund managers should give consideration to purchasing professional indemnity and directors' and officers' liability insurance. Another possible item is the purchase of "key man" life insurance to provide funding to the business in the event a key employee dies.

1.6.2 RECRUITMENT

In order to ensure the suitability of new employees, the manager should have in place appropriate recruitment procedures. Typically, such procedures would include an analysis of the specific role (job description), interviewing against that job description and undertaking appropriate due diligence checks on new employees. Such due diligence checks are likely to include seeking formal references. Written terms of employment should, if possible, be in place by the time an employee takes up appointment. Employment may also need to be conditional upon regulatory approvals. The fundamental determinant in selecting an individual for any particular role should be the competence of the individual to carry out that role.

1.6.3 TRAINING

All employees should undergo both induction training and continuous professional development training (much of which may be informal in nature). Such training should be designed to introduce the employee to the key business systems, procedures and compliance requirements and to ensure that employees remain up to date with the market, product developments and with changes in rules, laws and regulations. Managers should remain alert to the need for continued training and development of employees, particularly in rapidly changing investment environments or in cases where employees are changing or undertaking new roles.



2. Investment Process and Portfolio Risk Management

This chapter describes sound practices relating to the creation of an investment process, investment dealing and portfolio risk management. Some of these practices may be very intuitive for individual managers and small teams, but it is important to recognize that investment processes evolve over time. As a Hedge Fund manager grows and staff members change, clear communication about the investment process to both staff involved in its implementation and investors, will help to avoid misunderstandings and reduce the risk of errors.

The implementation of these processes will also depend on the size, complexity and strategy of the portfolio and should be tailored to individual Hedge Fund managers and the style of investment undertaken.

2.1 Investment Process

2.1.1 INVESTMENT STRATEGY

The investment strategy to be applied by the Hedge Fund manager must be clearly articulated to investors and understood by those executing it. With regard to investors, this requires adequate disclosure and explanation of how funds are to be invested, what factors will influence investment performance and what risks are associated with a particular investment strategy. The Hedge Fund manager must be cognisant of these matters and effectively communicate them internally. The Hedge Fund manager should:

- i. set out the investment objectives of the strategy;
- ii. identify any constraints the strategy imposes, e.g. types of products traded, size, amount of leverage, geographical and market limitations, position and risk limits;
- iii. identify the main risks and evaluate how such risks should be managed (i.e. avoidance, hedging or the decision to accept that risk);
- iv. comply with any applicable legal or regulatory constraints, including those documented in the relevant Hedge Fund prospectus or offering memorandum, and identify how such constraints affect the execution of the investment strategy;
- v. have due regard for the prospectus or offering memorandum issued in connection with the relevant Hedge Fund and meet the legal and/or regulatory requirements imposed by the Hedge Fund itself;
- vi. communicate material changes to the investment strategy on a timely basis; and
- vii. ensure the investment strategy is documented and kept up to date.

2.1.2 MANAGING THE INVESTMENT PROCESS

A Hedge Fund manager should have a defined investment decision-making process. There are a number of reasons for this:

- i. it provides an important control function with respect to the management of the investments;
- ii. it provides investors with an understanding of how the investments are managed; and
- iii. applicable regulations may require a Hedge Fund manager to adequately control the investment process.

Hedge Fund managers are often small organizations engaged in dynamic and opportunistic markets. Accordingly, the Hedge Fund manager's investment process should impose an investment management discipline, but should also be flexible enough to reflect the resources of the Hedge Fund manager and the market in which it is operating.



Any explanation of the investment process to investors or potential investors should accurately represent what happens in practice and be adhered to thereafter.

The process should be reviewed and updated regularly. Employees of the Hedge Fund manager should also understand the investment process and their role in it.

2.1.3 RISK PARAMETERS

Hedge Fund managers should assess and evaluate their appetite for risk in connection with a particular investment strategy and ensure that they make investment decisions within such parameters. Setting risk parameters both helps those implementing the strategy to be aware of the nature of the risks of the investment strategy and helps investors to understand how Hedge Fund managers are seeking to manage these risks. Individual Hedge Fund managers may have many different views on the risks involved in their investment strategies and how they attempt to measure these risks. Risk parameters may also help to formalize the investment process and investment strategy.

The Hedge Fund manager should routinely re-evaluate and re-assess its risk parameters.

2.1.4 POSITION MONITORING AND REVIEW

Hedge Fund managers should have a regular process for monitoring investment positions. This can be achieved through position and risk reporting generated internally or provided by a Hedge Fund's prime broker or administrator.

In addition to monitoring the daily profit and loss, the Hedge Fund manager should also take account of other relevant information when assessing individual positions and the overall portfolio, including:

- i. position sizes against any applicable limits or caps, whether self-imposed, disclosed to investors or imposed by applicable law or regulation;
- ii. ensuring availability of stock to support short sales made;
- iii. reconciling trades;
- iv. ensuring positions are being marked-to-market on a reliable and consistent basis;
- v. ensuring foreign exchange exposure is properly understood and addressed;
- vi. ensuring hedge positions have been appropriately adjusted for position and price changes or currency exposures;
- vii. monitoring pending corporate action and voting deadlines and ensuring that instructions are given and positions adjusted on a timely basis;
- viii. monitoring the maturity of swaps, derivatives and other term trades;
- ix. reconciling all credits and debits to the relevant account(s);
- x. monitoring investment income and distributions; and
- xi. assessing the timing and frequency of such reviews – which will vary depending on strategy and complexity of the portfolio and positions.

Further details on these procedures are discussed in Chapter 3.



2.2 Investment Dealing

Investment dealing is an important part of portfolio management and the Hedge Fund manager should develop a set of procedures to manage its interaction with the market and oversee the conduct of its staff that deal with counterparties in the market.

Canada has detailed regulations concerning investment dealing, including such requirements as the need for regulatory approval of firms and individuals, record keeping and reporting of transactions. Hedge Fund managers should ensure that they understand the regulations that apply to them and the markets in which they operate and should have adequate procedures to ensure that they remain in compliance with them.

2.2.1 DEALING PROCEDURE

Hedge Fund managers should have a defined dealing procedure, which illustrates how investment deals are placed in the market and what internal authorization or controls are required or imposed before the Hedge Fund manager executes a deal. At a minimum, Hedge Fund managers' dealing processes should be documented and should:

- i. set out, at a high level, the steps to be undertaken before a deal is placed in the market and the responsibility for monitoring the execution of that deal, maintaining the required records and its reporting;
- ii. identify any limits to investment dealing, such as size, nature, geographical, risk limits, counterparty limits, etc;
- iii. be clear as to who has the authority and regulatory approval to place investment deals and any limits to such authority;
- iv. be clear as to who has responsibility for overseeing the investment dealing process and monitoring the quality of execution both in relation to third party brokers and the Hedge Fund manager's own staff;
- v. where appropriate, maintain a segregation of roles between investment decision-making, dealing and trade confirmation and booking;
- vi. have a process to deal with trading errors and the impact on net asset value; and
- vii. ensure trading records are appropriately documented.

New employees joining Hedge Fund managers should be suitably trained and made aware of the investment dealing process before being allowed to place deals in the market.

2.2.2 BEST EXECUTION

The principles of best execution may be defined differently under the provincial regulatory regimes and Hedge Fund managers should ensure they understand the implications of, and comply with, the regulations applicable to them. Achieving best execution may not always be appropriate trade by trade, having regard to a particular investment strategy.

Subject to applicable regulatory requirements, a Hedge Fund manager may wish to formally contract out of providing best execution even if he tries to achieve best execution in practice.

2.2.3 TRADE ALLOCATION

Hedge Fund managers often operate a number of different investment vehicles, share classes, trading strategies and managed accounts. The fair allocation of trades amongst portfolios should be an overriding principle of business. It is an important control against a number of potential abuses such as front running and favouritism. Procedures to demonstrate that the principles of fair and prompt allocation are enforced should include:



- i. the adoption of an allocation policy which should be consistently applied, unless unusual circumstances arise (i.e. if it would be uneconomical to allocate a very small investment to a particular account);
- ii. recording the intended basis of allocation of all proposed transactions prior to the transaction taking place (i.e. prior to execution);
- iii. prompt allocation of all transactions after execution, usually on the trade date;
- iv. ensuring that no allocation is made to the account of the manager or a staff member unless it can clearly be demonstrated that it is in accordance with the intended basis of allocation and that all clients have received their full allocation; and
- v. documenting the reason for any reallocation from one account to another. Typically this would only be permitted where the original allocation can be shown to have been made in error.

2.2.4 USE OF DERIVATIVES

The different types of derivatives, the various conditions that affect their value, and the continually evolving derivative market can present considerable challenges and risks to derivative users. While many exchange-traded products are widely used and understood, there are many other derivatives that are individually defined, significantly more complex and potentially pose much higher risk if not used or understood properly.

Failing to identify, understand, and manage the risks associated with derivatives can result in sudden and significant negative impacts. If Hedge Fund managers intend to use derivatives they should:

- i. inform investors of their plan to use derivatives, typically in a prospectus or offering memorandum, and in their marketing material;
- ii. possess the necessary expertise and experience to properly understand how a derivative works and what factors will change the risk profile or pricing of the derivative;
- iii. ensure they have software or systems to support the derivatives traded;
- iv. ensure there are rigorous controls over entering into, collateralizing, recording and managing the expiry of derivatives;
- v. ensure they understand the legal documentation defining the nature of the derivatives and the terms of their clearance and/or settlement before signing the documents. If Hedge Fund managers do not have access to adequate in-house resources, reference should be made to expert legal advisers;
- vi. clearly understand the different implications of buying versus writing derivatives on positions in their portfolio and on the overall investment strategy, including leverage and risk;
- vii. ensure derivative positions are independently and consistently fairly priced, bearing in mind the market liquidity of such positions. For OTC contracts, trade counterparties are the most frequently used source of independent pricing. In addition to this pricing, Hedge Fund managers should periodically seek to independently check prices either through the use of models or appropriate counterparties; and
- viii. the Hedge Fund manager should discuss and agree to the accounting and valuation methodology employed with the client or administrator as appropriate and ensure that independent access is provided to the client or administrator directly from the pricing source.



2.2.5 CODE OF MARKET CONDUCT

Hedge Fund managers should conduct themselves in a manner in which a reasonable market participant would deem prudent, honest and reputable. Applicable law, as well as contracts, may impose requirements of honesty, good faith and standards of conduct. Canadian securities laws generally require that prospectuses and offering memoranda contain full, true and plain disclosure of all material facts relating to the Hedge Fund and impose liability on the Hedge Fund (and in some cases, the Hedge Fund manager) for misrepresentations (untrue statement of, or omissions to state, material facts).

Hedge Fund managers should ensure that they understand the implications of such regulation. Many of these laws and regulations may be complex and their application may be obscure. Hedge Fund managers should seek advice from the relevant professionals where they are uncertain about their application. Hedge Fund managers should also actively monitor sub-advisor's activities for adherence to all applicable securities requirements, including whether they are either registered or exempt from registration under Canadian securities and commodities futures requirements.

2.2.6 INDUCEMENTS AND SOFT COMMISSIONS

Inducements and soft commissions can be offered to Hedge Fund managers from a variety of sources. Care should be taken to ensure that inducements do not create unacceptable conflicts of interest or influence the Hedge Fund manager against acting in the best interest of its clients.

The practice of using soft commissions (or soft dollars) to pay for certain investment related services is permitted by some regulators, subject to a number of rules. Hedge Fund managers seeking to pay for investment-related services in this way should ensure that the service itself is a documented legitimate softing service of which clients have been made aware. In Ontario, soft dollars arising out of portfolio commissions may only be used by a Hedge Fund manager for order execution services and investment decision-making services as defined in the applicable policy. There are also limits on a Hedge Fund manager directing portfolio trades to, or at the request of, dealers who distribute the Hedge Fund manager's funds.

Any other forms of inducement, given to or received by Hedge Fund managers or their employees, should be monitored to ensure they are appropriate in the circumstances and not likely to unduly influence the judgment of the recipient. Hedge Fund managers should consider adopting the sales practices prescribed in National Instrument 81-105 Mutual Fund Sales Practices. This rule, which applies to most mutual funds offered by prospectus in Canada, limits the types of compensation paid to dealers, as well as imposing restrictions on marketing and other sales practices.

2.2.7 CONFLICTS OF INTEREST

The Hedge Fund manager should be aware that potential conflicts of interest might exist or develop. Where they do exist or develop, the Hedge Fund manager should ensure they are reviewed by the senior management of the Hedge Fund manager and by those people responsible for the compliance function. Hedge Fund managers may want to consider constituting a review committee, independent of the Hedge Fund manager, to review conflicts.

Once reviewed, the Hedge Fund manager should ensure such conflicts have been either appropriately dealt with or eliminated and disclosed to the relevant parties if this is considered to be necessary or is required by applicable law.

Hedge Fund managers should also ensure that they observe any relevant provisions of securities legislation concerning conflicts of interest and the management of investment funds.



2.2.8 PERSONAL TRADING

The Hedge Fund manager should adopt a personal trading policy that ensures that conflicts of interest between staff and clients are effectively managed. The easiest way to avoid conflicts of interest is for a Hedge Fund manager to prohibit personnel from trading on their own account in securities which they analyze or in which they invest for clients. Indeed there are perceived benefits for all if staff are encouraged to invest instead in the client Hedge Funds themselves, thereby aligning their interests with those of their investors. However this may not be appropriate or possible in all circumstances. Providing adequate controls exist, personal trading may be permitted. Hedge Fund managers may want to consider the personal trading requirements set out in the *Code of Conduct and Standards of Professional Conduct* of the Association for Investment Management and Research (AIMR) and the *Code of Ethics Guidelines for Personal Investing* of The Investment Funds Institute of Canada (IFIC).

For all personal account dealing the Hedge Fund manager should have:

- i. written policies and procedures communicated to and accepted in writing by all employees and reviewed and accepted on an annual basis;
- ii. pre-clearance and hard copy confirmation records of relevant transactions; and
- iii. monitoring and analysis of all personal dealings by a person competent to ensure proper management of the potential conflicts involved.

2.3 Portfolio Risk Management

Risk management is an important part of portfolio management and should be used to help reduce the likelihood of capital loss and failure. In many cases, Hedge Fund managers will not have a full time risk manager but they should ensure that they have a process in place for managing the level of risk in the Hedge Fund.

2.3.1 DEFINED PROCESS

There should be a defined risk management process in place, which is both realistic and is regularly used by the Hedge Fund manager, to manage and monitor risk. The process should include the following:

- i. Hedge Fund managers should identify and understand the sources of risks inherent in their investment styles or processes. As far as is possible these risks should be translated into relevant, measurable risk factors. Typically, a risk measure should estimate the impact of an event on the portfolio and the probability of this event occurring. Managers may consider including risk factors such as market risk, credit risk, liquidity risk, concentration, and counterparty risk. When considering risk, Hedge Fund managers should take into account the interaction between different types of risk;
- ii. Hedge Fund managers should define their attitude towards risk by documenting investment restrictions. Where appropriate, quantitative risk measure limits should also be provided; and
- iii. Hedge Fund managers should monitor risk on a regular basis. The investment decision makers should be informed on a timely basis about the current level of risk in the portfolio.

A risk management process should deal with both normal and exceptional conditions.



2.3.2 FREQUENCY OF REVIEW

- i. Hedge Fund managers should adapt the frequency of their risk monitoring to the needs of the portfolio. Monitoring would typically be continuous and should formally occur at appropriate regular intervals;
- ii. Hedge Fund managers should reconsider the overall risk management process from time to time to make sure that it remains suitable for the investment strategy. If risk systems such as risk models are in use, they should be flexible enough to allow modifications. A review of the process should typically be performed at least once a year and more frequently during exceptional conditions;
- iii. stress testing is one way to simulate exceptional market conditions;
- iv. Hedge Fund managers should elaborate scenarios to test the resilience of the portfolio. These scenarios should combine changes in the parameters relevant to the portfolio. Scenarios should include parameters such as current prices, term or forward prices, liquidity, volatilities, correlations and non-linearity;
- v. as one source of stress can impact another one, stress testing should cover the interrelationship between risks. Operational risk should be considered as one potential form of stress, although in practice it is difficult to stress test; and
- vi. a full portfolio stress test should be conducted as frequently as the Hedge Fund manager believes is required. A formal comprehensive stress test should normally be completed at least once a year.

2.3.3 INDEPENDENCE OF REVIEW

Hedge Fund managers should ensure the integrity of the risk monitoring function. Where practical, the manager should aim to segregate the risk monitoring function from the investment management function with different people responsible for each.

Where practical, independent personnel should periodically review the application and robustness of the risk management process, including the use of any risk models where used, and ensure that controls and limits are being adhered to.

2.3.4 MARKET RISK

Market risk includes all kinds of asset and liability price risk: price changes, volatility, non-linearity and correlation, foreign exchange and credit risk. Hedge Fund managers should:

- i. seek to identify each major category of market risk and regularly attempt to measure and manage these risks both individually and together;
- ii. be aware that there are many methodologies for measuring market risks and that these methodologies may result in wide differences in risk measurement; and
- iii. seek to manage the risk exposures of the portfolio within pre-defined internal and/or external guidelines. Excesses should be identified and corrected as soon as possible, either through hedging or position reduction.

2.3.5 LEVERAGE

Hedge Fund managers can access leverage in a variety of ways. For example, a Hedge Fund manager can obtain leverage through the use of repurchase agreements, short positions and derivative contracts (such as futures). Hedge Funds often use leverage in order to increase or enhance returns for a particular strategy. A Hedge Fund utilizing short selling to access leverage is using “gross” leverage if the total assets of the Hedge Fund (the sum of the absolute values of the long and short positions) exceed the net equity of the investors in the Hedge Fund, and is generally expressed as a ratio whose value will exceed 1:1.



A Hedge Fund manager should recognize that leverage is not an independent source of risk; rather, it is a factor that influences the rapidity with which changes in market risk, counterparty risk or liquidity risk factors impact the value of a Fund’s portfolio. A Hedge Fund manager should assess the degree to which a Hedge Fund is able to modify its risk-based leverage in periods of stress or increased market risk.

Hedge Fund managers should clearly define and disclose to investors the way they measure leverage and the maximum level to be employed in support of the strategy. The maximum amount of leverage which can be employed may be constrained by such things as contractual terms which limit the type or amount of derivatives used by the Hedge Fund manager and/or the lender’s allowable margin levels. The Hedge Fund manager should consult a professional advisor for any tax implications associated with leverage.

The amount of leverage, as defined by the Hedge Fund manager, should be monitored regularly. In many cases, daily monitoring will be appropriate. Hedge Fund managers must ensure that leverage remains within any established constraints.

2.3.6 LIQUIDITY

Both the liquidity of individual positions and the overall portfolio should be actively managed to ensure a portfolio can meet its liquidity requirements, including allowing investors to withdraw in accordance with the agreed contractual terms.

Market liquidity (i.e. capacity to trade assets) is usually an important risk factor. Therefore, it should be measured and monitored.

Funding liquidity (i.e. available sources of finance to fund positions and redemptions) is a critical risk, highly correlated with other risks. The portfolio’s cash requirements should be monitored against available sources of finance. Usually, prime brokers are the major providers of financing.

Liquidity should be managed by having proper procedures, especially fair and documented withdrawal policies, both in normal conditions and in periods of stress.

2.3.7 COUNTERPARTY EXPOSURES

Often, the vast majority of trades entered into by Hedge Fund managers will be delivery versus payment transactions, which involve less counterparty exposures. There are, however, other types of trades and periods of sudden stress where counterparty exposures can become significant. Creditworthiness or solvency of a counterparty can become a risk particularly when there are significant unexpected changes. Because this risk is usually not hedged, managers should be aware that this might become a source of risk.

The Hedge Fund manager should have defined procedures for establishing relationships with new counterparties, undertaking a high level review of the quality of the counterparty, performing credit reviews and for maintaining the necessary documentation. A prime broker should be considered a significant counterparty.



3. Portfolio Administration and Operational Controls

This chapter identifies sound practices for trading, movements of cash, pricing of portfolios, managing service providers and maintaining appropriate information systems. Ultimately, many of these processes will be more or less involved depending on the size, complexity and strategy of the portfolio. Hedge Fund managers often operate separate managed accounts as well as multiple Hedge Funds; the processes and controls for both should be similar.

Many Hedge Funds have an independent administrator. For many Hedge Fund managers, a prime broker or custodian is also an important service provider to provide effective clearance and settlement as well as position and portfolio reporting. Day to day, the Hedge Fund manager is responsible for liaising with and monitoring information flow between itself, the administrator and the prime broker.

Before the launch of any Hedge Fund and the appointment of any service providers, it is important that the particular needs of the relevant investment strategy, and the processes for its execution, are identified.

Once the necessary service providers are identified, there should be careful negotiation of their contracts, including specific service standards, to ensure that they reflect the particular requirements of the Hedge Fund. The Hedge Fund manager should understand the key provisions of such contracts. Appropriate due diligence should be undertaken and documented by the Hedge Fund Manager to confirm that the service provider has the requisite level of expertise and technology to deliver the services required to effectively support the investment strategy and investor base.

In Canada the review and testing of operational controls is an area of focus for regulators in their review of regulated Hedge Fund managers. The Ontario Securities Commission (“OSC”) has produced a useful report outlining particular common problems found from manager reviews and suggested best practices. This report can be obtained from the OSC and also includes a listing of all the books and records that will be requested during a review. Hedge Fund managers should maintain an operational procedures manual outlining all major procedures and processes followed by the manager or the Hedge Fund.

3.1 Trade Procedures

The Hedge Fund manager is responsible for ensuring that all trading transactions are properly authorized, recorded and settled. In some cases, the Hedge Fund manager may want to outsource the conduct of some or all of these activities, although it remains ultimately responsible. If activities are outsourced, it is important to verify that the outsourcing counterparty has appropriate procedures and controls in place.

- i. The Hedge Fund manager must establish procedures and documentation to support trading activities and decisions made. Such documentation should include required authorization or signatures by designated portfolio managers.
- ii. The Hedge Fund manager may have the authority to open prime broker and executing broker accounts for the Hedge Fund. In this situation, the Hedge Fund should be regularly informed as to the full list of broker accounts opened and terms of operation. Individuals authorized to execute trades or other transactions on behalf of the Hedge Fund must be documented, with details, such as names and signatures, provided to the counterparties with whom the Hedge Fund is dealing.
- iii. Once a trade has been executed, all the details of the trade must be recorded. This can be done by recording the trade details on a trade blotter, entering the trade into a position keeping system or writing a trade ticket for processing by an operations group.



- iv. Details which need to be recorded include:
 - a) the security traded (generally the exchange symbol and CUSIP/SEDOL identifier);
 - b) the counterparty with whom the trade was executed;
 - c) the time of the trade;
 - d) the type of trade, i.e. buy, sell, short, cover;
 - e) the form of the transaction such as ordinary, CFD, swap, forward etc.;
 - f) the quantity of units traded;
 - g) the price;
 - h) the trade and settlement date; and
 - i) the commission rates and any other charges (such as SEC fees charged on some U.S. transactions).
- v. If the trade is to be allocated over different accounts, the method to be used needs to be recorded. This can either be trade specific or a general principle (e.g. allocation proportionate to assets in accounts) that is documented in the Hedge Fund manager's operations manual. Operational procedures should be in place to ensure that the methodology is followed.
- vi. All trades should be confirmed with the counterparty. It is a sound practice to confirm the trade details with the counterparty on trade date as this reduces any likelihood of problems, such as failed settlement or incorrect risk measurement of the portfolio. Details of the trade should be passed to the prime broker and to the administrator if applicable. In most cases this will be done electronically, thereby reducing the risk of error in re-keying any information.
- vii. The Hedge Fund manager should create a log of trades sent so that all trades and trade details can be accounted for. The log, as well as broker statements, confirmation slips etc., should be kept for a period as required by various regulatory document retention requirements.
- viii. Wherever possible, standard settlement instructions should be used to reduce the risk of incorrect details on any trade.
- ix. The Hedge Fund manager should subsequently reconcile the prime broker's and administrator's records of positions against its own records on a regular basis, at a minimum monthly. Such reconciliations should be performed and documented by an individual or group independent from trading or portfolio management.

3.2 Non-Trading Transactions

The controls relating to the banking and other business arrangements of a Hedge Fund are critical to the overall control of non-trading transactions undertaken. Hedge Funds will typically use a combination of banks, prime brokers and administrators for their cash processing and, as such, can use the controls inherent in those service providers' systems as part of the control environment for the Hedge Fund. There are, however, key controls that are required by the Hedge Fund manager itself to enable non-trading transactions to be securely handled. The controls required for these transactions are different from those associated with trade processing as they need to cover subscription receipts, redemption payments, transfers, and expense payments. The key areas of control are account opening, transaction authorization, bank account reconciliation and investor transactions.

- i. Bank account opening
 - a) The Hedge Fund manager will typically open a trust account at a bank for the Hedge Fund and will operate the account on its behalf. The account opening documentation will include an authorized signatory list and any appropriate limits on those authorizations. The account will be used solely for fund related transactions and must be kept separate at all times from the Hedge Fund manager's own company activities. There are strict regulatory prohibitions against the commingling of investor and Hedge Fund manager funds.



b) The Hedge Fund manager may delegate some authority over the bank account to the administrator to facilitate the processing of items such as subscriptions and redemptions. etc. As such, the administrator will be an authorized signatory and should provide up to date signatory lists.

ii. Transaction authorization

- a) All transactions through the bank or prime brokerage accounts should be authorised in accordance with the terms of the account. It is generally considered good practice to require two signatures in order to authorize any movement of Hedge Fund cash or securities.
- b) All supporting records, appropriately authorized, must be maintained for transactions through the bank account. The Hedge Fund manager should ensure that adequate procedures are in place to monitor transactions through the bank account, particularly subscription and redemption flows, in order to ensure timely settlement and to avoid overdrafts.
- c) At each month end the bank and the prime broker or custodian will post income and expense items to the bank and prime brokerage accounts. These items will include, amongst others, interest income and expense, stock loan fees and other financing costs, etc. The Hedge Fund manager should have adequate systems to check the accuracy or reasonableness of these postings.

iii. Account reconciliation

- a) The Hedge Fund’s administrator and the Hedge Fund manager should reconcile their respective bank account records on a regular basis. Cash balances at the prime broker or custodian should be reconciled daily.
- b) Operational procedures should be in place to ensure that all reconciling items should be recorded and resolved on a timely basis.
- c) Valuations should not be issued unless all bank accounts have been satisfactorily reconciled.

iv. Investor transactions

- a) The Hedge Fund manager or administrator will typically use a trust bank account for the receipt of subscriptions or payment of redemptions. Funds are then authorized for transfer to the prime broker or to the investor in the case of redemptions.
- b) To enable private investors through their Broker/Dealer to invest in the Hedge Fund, the Hedge Fund manager or administrator may elect to subscribe to the services of FundSERV. FundSERV is the electronic communication network employed by both dealers and fund companies in Canada to send and receive fund orders and send and receive funds for the settlement of fund trades. Brokers/Dealers enter an order on their back office system and through FundSERV and the Hedge Fund manager or its administrator receives and processes the order. FundSERV works on a net settlement basis so that both orders and redemptions are combined resulting in only one payment to either the Hedge Fund manager’s trust account or to the dealer’s trust account.
- c) The Hedge Fund manager is ultimately responsible for accepting investors into the Hedge Fund. Appropriate procedures should be in place to ensure that only qualifying investors, under the Hedge Fund manager’s policies and applicable securities law requirements, are accepted. If the Hedge Fund manager has contracted the screening of investors to an administrator, the Hedge Fund manager should ensure that appropriate pre-screening procedures are in place at the administrator and should regularly obtain records of subscriptions and redemptions for review. This will enable the Hedge Fund manager to monitor and manage its cash flow requirements. The Hedge Fund manager should also maintain an investor listing or database evidencing its due diligence to ensure that it has satisfied itself that investors qualify as purchasers under available securities exemptions. These would include documentation establishing an investor’s status as an “accredited investor”, “eligible investor” or “sophisticated purchaser”, as applicable. Where dealers or other sales intermediaries are involved, at the point of sale, the dealer accepting



investments from investors must understand the legal qualifications that must be met by investors in the relevant jurisdiction. The dealer also must have appropriately drafted investment applications and risk acknowledgement forms (where necessary) to document each investor’s qualifications and consent to the investment.

- d) Hedge Fund managers must also familiarize themselves with required anti-money laundering and anti-terrorism requirements. The requirements in Canada are monitored and published by the Financial Transactions and Reports Analysis Centre of Canada (FINTRAC), a specialized agency created by the federal government under the *Proceeds of Crime (Money Laundering) and Terrorist Financing Act*. In addition, Canadian Hedge Fund managers registered as advisers and/or dealers are required to make a monthly signed filing with the securities regulatory authority in the jurisdiction where their head office is located (i.e. with the OSC for Ontario based Hedge Fund managers) attesting that they have no clients who are on official terrorist lists, or reporting same.
 - e) All companies in Canada, including Hedge Fund managers, are subject to the *Personal Information Protection and Electronic Documents Act* or PIPEDA, or its provincial equivalent in those provinces whose privacy legislation has been recognized. This legislation establishes requirements for the protection and handling of all personal information about clients, including consent to the collection and usage of such information. The Hedge Fund manager should ensure that appropriate procedures are in place for compliance with PIPEDA or its provincial equivalent. This also includes ensuring that there are the procedures in place at any service provider who receives or holds personal investor information.
- v. Management, Performance and Administration Fees and Other Accruals
- a) The methodology for the calculation of performance, management and administration fees should be clearly disclosed in the offering document for the Hedge Fund.
 - b) The calculation of performance, management and administration fees will typically be undertaken by the administrator, when one is employed. The Hedge Fund manager should have procedures and systems (independent of the administrator) in place to check these fee calculations and to enable the Hedge Fund manager to include realistic fee accruals into any intra-month or intra-period net asset value reporting to investors. This is particularly important for the calculation of performance fees in the first year. The basis for calculations should be clearly documented at each valuation date.
 - c) The Hedge Fund manager should monitor any other accrued income or costs, such as dividends payable, interest receivable or payable, audit fees, directors’ expenses or any other significant costs.



3.3 Portfolio Valuations

3.3.1 PRICING POLICY

Procedures should be in place to allow investors to have a clear understanding of how the portfolio is priced and valued. Depending on the Hedge Fund or segregated account portfolio, valuations may be provided by the Hedge Fund manager, the prime broker or custodian, or the administrator. The key controls to be addressed are:

- i. the valuation methodology should be clearly documented and included in the Hedge Fund’s prospectus or offering memorandum. If investors are provided valuations by the administrator and preliminary estimates by the Hedge Fund manager, investors should be informed of any material differences;
- ii. Hedge Fund valuations should utilize independent pricing sources wherever available. At each valuation date documentation of the prices used and the sources should be maintained; and
- iii. when a portfolio contains illiquid securities, or securities for which an exchange price is not readily determinable (such as, for example, unlisted securities, OTC securities etc) it is important to ensure that a pricing policy is in place that allows for the systematic, consistent and transparent valuation of such securities in a manner that does not impair the Hedge Fund manager’s either actual or perceived independence in the process.

3.3.2 VALUATION RECONCILIATIONS

Regular reconciliations should be undertaken to ensure that differences between service providers are swiftly resolved.

Regular reconciliations should be undertaken between the Hedge Fund manager, the prime broker and the administrator. The reconciliation should cover both cash and portfolio positions. For most Hedge Funds, it is likely that reconciliations will be undertaken daily with the prime broker, and weekly or monthly with the administrator.

Differences should be resolved promptly and corrected in the appropriate system.

3.3.3 MONITORING INVESTMENT RESTRICTIONS

Investment restrictions are intended to provide limits and controls on a Hedge Fund manager’s investment activity and as such to provide investors with an assurance as to the level of risk inherent in the manager’s investment strategy. They also serve to ensure that the Hedge Fund investments are in accordance with the declared mandate. Hedge Fund managers must continually monitor the adherence to such restrictions in the following ways:

- i. investment restrictions should be clearly stated in a Hedge Fund’s prospectus or offering memorandum. References to investment restrictions in other marketing material generated must be consistent with the prospectus or offering documents;
- ii. the restrictions should be sensible and realistic with respect to the relevant investment strategy and should comply with any regulatory requirements. Hedge Fund managers may set tighter restrictions in-house in order to have an early warning as to when the external restrictions are being approached;
- iii. the restrictions should be regularly monitored by the Hedge Fund manager. The monitoring should be done by a party independent of the portfolio management or trading activity;
- iv. the restrictions should be monitored on a timely basis to ensure that they are not breached at trade entry but, if this happens, the issues are identified and resolved promptly; and
- v. clear procedures should be documented to resolve any investment restriction breaches should they occur.



3.4 Managing Service Providers

Service providers' roles, responsibilities, service level commitments and liability should be clearly documented and their performance should be periodically reviewed and documented by the Hedge Fund manager.

The Hedge Fund manager should have regular contact with the service providers to establish good relationships, monitor and review information flows, deal with issues as they arise and continue to look for ways that the service providers can add value.

3.4.1 PRIME BROKERS

It is important that the Hedge Fund manager understands the role of the prime broker and, amongst other things, the cost, financing and securities lending structure, as well as all material provisions of the prime brokerage documentation such as margin calls, synthetic products trading, segregation of assets, events of default etc.

The prime broker's functions will generally include:

- i. clearing;
- ii. custody;
- iii. brokerage;
- iv. margin financing (i.e. providing leverage);
- v. reporting;
- vi. stock lending; and
- vii. various value added services.

It is important when deciding upon a prime broker to consider not only the services the prime broker will provide but also, how it will deliver them. Most processes should be automated for the delivery of information to the Hedge Fund manager and administrator. The Hedge Fund manager should expect to receive electronically at least daily portfolio, margin and cash reporting and should on a daily basis, review this information and raise any errors with the prime broker. Generally, the following factors should be considered in evaluating a prime broker and its documentation:

- i. interest rate and fee structure;
- ii. the prime broker's familiarity with and internal resources available to service the investment strategy;
- iii. the amount of leverage the prime broker is prepared to provide and the basis on which this is provided (e.g. the use of a risk-based system);
- iv. extent of segregation and ownership of assets;
- v. the exposure to the credit of the prime broker; and
- vi. the value added services provided.

The Hedge Fund manager should seek confirmation from the prime broker that information furnished to its credit desk by the Hedge Fund manager will not be shared with any trading personnel without the Hedge Fund manager's consent.



3.4.2 ADMINISTRATORS

In addition to the Hedge Fund manager, the administrator is often the investors' main contact.

The administrator's functions can include:

- i. co-ordinating the opening of bank accounts for the Hedge Fund;
- ii. receiving and processing subscriptions and redemption requests;
- iii. setting up and co-ordinating adherence to FundSERV standards and controls;
- iv. producing and reporting net asset value calculations;
- v. independent pricing and reconciliation of the portfolio;
- vi. computing management and performance fees;
- vii. preparing accounts;
- viii. maintaining the shareholder register;
- ix. arranging payment of dividends or distributions (if necessary) and redemption proceeds;
- x. coordinating communications with investors; and
- xi. implementing anti-money laundering and anti-terrorism procedures.

It is recommended that periodic reviews are performed of the services being rendered. This is sometimes best achieved by on-site visits with the administrator. In addition to regular reconciliation of trades with the administrator and the prime broker, the Hedge Fund manager should regularly monitor and review the net asset value calculation and other services, such as anti-money laundering procedures which are performed by the administrator. However, as a registrant, the Hedge Fund manager has not outsourced its responsibility for compliance and will be required to maintain sufficient controls in this area.

3.4.3 BROKERS

A Hedge Fund manager may trade with multiple executing brokers and use the prime broker as settlement agent for the trades or it may use multiple prime brokers. While many of the issues already referred to are equally applicable, the importance of the capture of the trade data by the administrator, the cash management and the reconciliation processes involving the Hedge Fund manager are heightened due to the increased number of parties involved.

It is important that the Hedge Fund manager always knows by which executing broker and prime broker a trade is being handled.

It is also important that the appropriate bank and broker mandates are in place in order for cash movement between authorized brokers to take place.

3.4.4 OTHER SUPPORT FUNCTIONS

The Hedge Fund manager may also outsource certain other business operations such as payroll processing, bookkeeping and IT support. Service suppliers should be selected carefully to ensure that an adequate service is delivered.

3.4.5 PROFESSIONAL ADVISORS

Lawyers and/or accountants will be instructed in the set up process to advise on structuring the Hedge Fund, to produce the fund documentation, review service provider agreements, conduct audits and advise on other issues.



3.5 Information Systems and Business Continuity

3.5.1 INFORMATION SYSTEMS

There should be high standards of security and integrity over the computer systems that are used by the Hedge Fund manager. Such systems might include, inter alia:

- i. order processing systems;
- ii. portfolio management systems;
- iii. risk management systems;
- iv. research systems; and
- v. accounting systems.

The systems should be developed, implemented and maintained in a controlled manner. The existence of the different systems in use and their interaction should be documented. The systems used will vary between Hedge Fund managers depending on the size, investment strategy and volume of transactions being managed; it is for the Hedge Fund manager to determine the most appropriate systems required to manage the business. Inevitably, the operations of the Hedge Fund manager will be heavily dependent on the proper functioning of the systems and the integrity of the information produced by those systems. It is preferable to have automated links between the Hedge Fund manager, the prime broker and the administrator. Systems infrastructure may be located in-house or outsourced to third party suppliers and therefore there will be differences in control procedures. However, the key controls that should be addressed are:

- i. Core computer systems should be physically secure to prevent unauthorized access to the data processing area.
- ii. Electronic access to the systems should be controlled and limited to authorized personnel. Access to different levels of the data processing systems should be protected by the use of a Public Key Infrastructure (PKI) or readily changed passwords and other arrangements. These systems should be programmed to prevent and detect unauthorised access and any attempted breaches of security should be logged and appropriately followed up.
- iii. Network file servers and computers should be protected by virus protection software. The internal network should be protected by a firewall against unauthorized access from external networks, including the Internet.
- iv. The systems should provide a complete and accurate trail of transactions processed and appropriate procedures should exist for archiving, safe storage retention and retrieval of computer records. This would include daily, weekly and monthly back-ups of the system and off-site storage of back-up tapes.
- v. Amendments to systems should be properly authorized, tested and documented. This will enable modifications to the systems to be implemented in a controlled manner. Often this process may be outsourced to a specialist firm and it is important that such a firm has the requisite skills to modify the systems.

3.5.2 BUSINESS CONTINUITY

The Hedge Fund manager should develop a business continuity plan for recovery in the event of a disaster. This should allow for the recovery of all key operations at a disaster recovery site. The disaster recovery plan should include procedures for contacting key staff and access to back-up data stored off-site. The disaster recovery plan, including a full systems test, should be tested on a regular basis. It is in the Hedge Fund manager's interests to ensure other service providers have similar programs in place and their existence should be part of any service contracts.



3.5.3 RECORDS AND DOCUMENTS

The Hedge Fund manager must ensure that all record and document retention requirements are met. This is important for business continuity as well as to ensure that all regulatory requirements are satisfied. Although counsel should be consulted, in general terms, the following rules apply in Canada:

- i. corporate records, such as directors minutes, contracts, general ledgers, must be retained for 2 years after the dissolution of the corporation;
- ii. accounting and tax records, along with supporting documentation, must be retained for six years after the end of the last taxation year to which they relate; and
- iii. client records, such as account opening documents, signature cards and transaction statements, must be kept for five years after the closing of the clients' accounts



4. Raising Capital and Investor Relations

4.1 Marketing

Raising adequate capital and attracting suitable investors are often key determinants of the success of a Hedge Fund management business. When promoting their services and marketing the Hedge Funds whose investments they manage, Hedge Fund managers need to consider a variety of complex issues, including:

- i. regulations on promotion and marketing;
- ii. targeting and attracting investors;
- iii. anti-money laundering and anti-terrorism requirements;
- iv. special agreements with investors;
- v. adequate disclosure of information;
- vi. timely disclosure of information; and
- vii. disclosure to all investors.

These issues are discussed in more detail in this chapter.

4.1.1 REGULATIONS ON PROMOTION AND MARKETING

Hedge Fund managers must be conscious of the regulatory restrictions that apply to promoting their services and marketing the Hedge Funds whose investments they manage. Hedge Fund managers may need to have regard for the regulations of several jurisdictions; where they operate, where they seek investors and the domicile of the Hedge Funds. Breach of these regulations can lead to severe consequences, including investor suits, fines, rescission rights and criminal sanctions as well as reputational damage.

Hedge Funds for which a listing on a stock exchange is sought may be subject to additional limitations on the type of investors who can invest and specific disclosures that must be made to these investors.

- i. Promotion by the Hedge Fund manager. A Hedge Fund manager will generally require authorization by the regulatory authority in the jurisdiction in which it is established and in which it operates. Canadian securities laws generally require registration as a dealer for trading in securities, including acts in furtherance of a trade. While exemptions from registration may be available in most jurisdictions for trades under prospectus exemptions, in Ontario, market intermediaries in the exempt market are required to register with the OSC as limited market dealers. The local regulations will often restrict the manner in which the Hedge Fund manager may promote its services, including restrictions on the type of investors that may be contacted, the type of communications that may be made (including, for example, presentation of past performance or “track record”) and legends that must appear in marketing materials. Use of publicly available media, such as the Internet, to promote the Hedge Fund manager’s services will also be subject to restriction.
- ii. Private and restricted offerings. In most jurisdictions, Hedge Funds may be offered on a private basis only. For example, the offering may be limited to the investment being at or above a certain amount and/or to investors who meet certain threshold eligibility as “accredited investors”, “eligible investors” or “sophisticated purchasers”, depending upon the province or territory in which an investor resides and the prospectus exemption being relied upon. These eligibility requirements generally require that the investor either be an institutional investor, such as a financial institution or pension plan, satisfy professional investor status or meet minimum income or asset thresholds. These eligibility requirements vary across jurisdictions in Canada and Hedge Fund managers should be aware of subtle and technical differences. For example, a number of jurisdictions, including Ontario, have a registration and prospectus



exemption for trades involving investments of at least \$150,000. However, in Ontario, the exemption is not available unless the fund manager is a registered portfolio advisor. A Hedge Fund manager must file with securities regulators reports of any exempt trades within prescribed time periods. Note that the filing requirements are not the same across the country and that there are filing fees.

- iii. Registration of the marketer. If the Hedge Fund manager plans to market a Hedge Fund or its services, it may have to be authorized in the jurisdiction in which the marketing will occur or be directed. In some cases, the Hedge Fund manager may be able to “passport” in to another jurisdiction based on its regulatory authorization in its home jurisdiction. If the Hedge Fund will be marketed by third-party marketers, the Hedge Fund manager should seek assurances that the third party marketer has all requisite regulatory approvals to conduct the marketing. In Canada, any activity involved in marketing or promoting sales of a Hedge Fund could be considered acts in furtherance of a trade in securities. Securities laws in Ontario define “trading” to include advertising, soliciting or negotiating, directly or indirectly, in furtherance of a trade in a security. Registration is required to engage in such activity. It may be prudent to have marketing materials and promotional activities reviewed by legal counsel to ensure appropriate disclosure e.g. conflicts of interest.

The complexity of applicable restrictions and the gravity of the consequences of their breach means that a Hedge Fund manager should consider the need to consult a professional adviser familiar with the laws of the local jurisdiction before undertaking any marketing. As these restrictions can seriously impact fund raising, this analysis should be undertaken early in the process of considering the launch of a new Hedge Fund manager or Hedge Fund.

4.1.2 TARGETING AND ATTRACTING INVESTORS

A balanced investor base is often a goal of the Hedge Fund manager as achieving this can help to ensure a stable equity base for the fund and minimize volatility, therefore bringing benefits to all investors.

A Hedge Fund manager should prepare a marketing plan that focuses on the type and scale of investors that it will seek to attract. This plan can also act as a key input in assessing the viability of a new venture and allowing the Hedge Fund manager to reach a more objective judgement on potential investor requests for different terms and conditions. In establishing a Hedge Fund, consideration should be given to the structural preferences that the target investors may have.

There are various distribution channels available for a Hedge Fund manager to promote a Hedge Fund. Introductions by the prime broker and by the fund administrator can be part of the process of securing investment, and these may be utilized alongside other sources of investors.

4.1.3 ANTI-MONEY LAUNDERING AND ANTI-TERRORISM REQUIREMENTS

It is important that all those involved in promoting/distributing a Hedge Fund understand their role in preventing money laundering and terrorist financing.

The Hedge Fund manager should ensure that a senior individual is responsible for such procedures (see Section 3.2 (iv)(d)) and that all employees are kept up to date with developments in this area. The Hedge Fund manager should also ensure that appropriate procedures and controls are in place to ensure that the relevant rules and requirements are met particularly when marketing to potential investors.

4.1.4 SPECIAL AGREEMENTS WITH INVESTORS (“SIDE LETTERS”)

Individual investors may seek to maximize disclosures and/or negotiate preferential terms for their investment. In such circumstances the Hedge Fund manager should continue to attempt to treat all investors as equally as possible and continue to respect all legal and regulatory requirements. Agreeing to special terms may have significant legal consequences with long-term implications for



both the Hedge Fund and the Hedge Fund manager. In addition, special terms agreed to with early investors in a Hedge Fund can, as a business matter, hamper the Hedge Fund as it expands. In particular, “most favoured nation” provisions, by which an investor has a standing right to the best terms offered to any new investor, should be considered carefully in advance. Legal advice should be sought before agreeing to any such special conditions and side letters.

Alternative arrangements may also be made for investors to invest through managed accounts. Again, the Hedge Fund manager should consider carefully both its ability to meet any special requirements and terms and the impact that any such arrangements may have on other clients and/or investors.

4.1.5 ADEQUATE DISCLOSURE

Hedge Fund managers should provide adequate disclosure of information to investors on a consistent and timely basis. The following suggests the key objectives that disclosure to investors should aim to achieve:

- i. information provided to investors should be prepared on a consistent basis and be presented in a clear manner. Where significant assumptions have been used in preparing the information, these should be clearly explained and consistently applied;
- ii. as far as possible Hedge Fund managers should advise investors before they invest of the form, content and timing of regular information that will be communicated to them;
- iii. portfolio information should be provided to investors on a periodic basis and should allow investors to determine, in summary form, how accounts are invested;
- iv. performance information should be made available to investors to allow them to understand how an account has performed. It is suggested that the provision of historical performance data be audited and presented in compliance with Association for Investment Management and Research (AIMR) standards. The Hedge Fund manager’s role will be crucial in preparing this information, although the administrator may help facilitate the provision of this information to investors in a Hedge Fund; and
- v. exceptional disclosures should be made to investors if there have been significant changes in how an account is managed, changes to key investment personnel and any major changes in the infrastructure of the Hedge Fund manager and/or service providers to the account.

If a Hedge Fund is a “reporting issuer” (e.g. its securities are, or were, sold by way of prospectus) under Canadian securities law it will be required to file financial statements and other information with regulators and send such information to investors within prescribed time periods. In some jurisdictions, even Hedge Funds that are not “reporting issuers” because their securities are only sold on a prospectus exempt basis may have to file financial statements with regulators unless an exemption is obtained. Documents required to be filed with securities regulators are filed electronically on the SEDAR system through which investors and the general public can access such information over the Internet.

Hedge Fund managers relying on prospectus exemptions often choose to provide an offering memorandum and in some cases it is required. Regardless of whether they are voluntary or mandatory, offering memoranda must meet certain legal requirements addressing content and providing copies to regulators.

4.1.6 TIMELY DISCLOSURE OF INFORMATION

Disclosure to investors should be made as soon as reasonably practicable, bearing in mind the need to protect all investors’ interests and any applicable legal or regulatory constraints. Often, the Hedge Fund will be subject to regulatory requirements that mandate the production of accounts or other information, an independent audit, and their filing with relevant regulatory authorities within a certain time period. The Hedge Fund manager should be aware of these requirements and monitor compliance with them. The Hedge Fund manager should:



- i. ensure regular communication to investors of results promptly after the net asset value is finalized;
- ii. maintain an up-to-date investor contact database to facilitate the effective and timely distribution of important information; and
- iii. aim to organize itself in such a way as to allow it to complete all investor contact as soon as practicable, particularly if a Hedge Fund manager has important disclosures to make and wishes to do so by telephone or in person.

4.1.7 DISCLOSURE TO ALL INVESTORS

The Hedge Fund manager should aim to disclose information about material items and changes to all investors who will be affected by such items and changes.

- i. A Hedge Fund manager should seek not to differentiate communications to investors either in terms of the nature, content, manner or timing of disclosures, except as justified by the different relevance of the communication to the investors.
- ii. Investors should be able to direct questions to a small number of key personnel at the Hedge Fund manager and expect a timely response to questions irrespective of the size of their investment. A Hedge Fund manager should devote adequate resources to responding to investor queries (made either directly or through the administrator).



5. Hedge Fund Structure and Organization

While the foregoing chapters have focused largely on sound practices in connection with Hedge Fund managers, this chapter summarizes various sound practices with respect to Hedge Funds. It should be noted that because Hedge Funds take many different forms and structures and vary with respect to type and complexity of investment strategy and products traded, some of the sound practices outlined in this chapter may include items more relevant to some Hedge Funds than to others. This Guide emphasizes Canadian domiciled Hedge Funds and Hedge Fund managers rather than offshore-based Hedge Funds.

A Hedge Fund's structure should be based on a realistic assessment of the needs and preferences of its anticipated core investors. Careful analysis of the initial structuring of the Hedge Fund can help avoid delay and further expense spent in restructuring the Hedge Fund at a later date.

Investors are likely to have certain expectations and preferences before they invest in a Hedge Fund, including:

- i. whether the Hedge Fund is established in a jurisdiction that is familiar to them;
- ii. whether the Hedge Fund is established in a particular form (e.g., company, limited partnership, unit trust);
- iii. the structure's tax consequences for the Hedge Fund and the investor;
- iv. the extent and frequency of reporting (financial results and/or investor updates from the Hedge Fund manager);
- v. whether the Hedge Fund is open end or closed end;
- vi. the frequency of and any limitations on dealing (subscriptions and redemptions and minimum investment amounts);
- vii. the level of management and performance fees;
- viii. the investment strategy, anticipated leverage, risk profile, investment restrictions; and
- ix. whether or not the Hedge Fund is listed.

In structuring a Hedge Fund, consideration should also be given to retaining enough flexibility to accommodate any contemplated expansion in the type of investors being targeted.

5.1 Structure of the Hedge Fund

Typically, a Hedge Fund is sponsored by the Hedge Fund manager or its marketer. The Hedge Fund manager should plan the structure of the Hedge Fund in consultation with the Hedge Fund's proposed marketer (if different from the Hedge Fund manager) and professional advisers, having regard to the above considerations.

5.1.1 LEGAL STRUCTURE OF THE HEDGE FUND

A Hedge Fund will normally be a separate legal entity from the Hedge Fund manager. Hedge Funds may be structured in a variety of forms, including limited liability companies, limited partnerships and unit trusts. Hedge Fund structures can often accommodate more than one of these forms using "master-feeder" structures.

i. Hedge Fund domicile

Hedge Funds may be established in any jurisdiction that has suitable legal provisions for the formation of the proposed investment vehicle and its business. The domicile ultimately selected for the Hedge Fund should be determined by weighing several factors:

- a) the amount of regulation and taxation imposed in the proposed jurisdiction, the time required to gain provincial regulatory approval and the flexibility of provincial regulation;



- b) formation costs and ongoing expenses (e.g., annual registration costs);
- c) service provider requirements and the availability and quality of local service providers;
- d) jurisdiction of targeted investors and their familiarity with and preferences concerning the Hedge Fund’s domicile;
- e) the Hedge Fund manager’s domicile and its familiarity with the Hedge Fund’s domicile; and
- f) any difficulties arising from the remoteness of the proposed jurisdiction (e.g., time zone differences).

The province or territory in which the Hedge Fund manager is located may have an impact on any regulation applicable to the Hedge Fund. The Hedge Fund manager should consult with appropriate experts in determining the Hedge Fund’s domicile.

ii. Taxation issues

Different structures may have different advantages for different investors. Expert legal and tax advice should be taken at the outset to ensure that the activities of the Hedge Fund (including its directors and its Hedge Fund manager) do not prejudice its tax status.

iii. Listing closed end vehicles

Hedge Funds structured as closed end vehicles may want to consider listing on a recognized stock exchange. This may open the Hedge Fund to investors which are restricted in their investment in unlisted securities. It may also relieve the Hedge Fund from limitations on its investment in illiquid securities which may be necessary if the Hedge Fund is redeemable. Advice should be obtained on the additional costs associated with the listing and continuing obligations as a result of the listing.

5.1.2 PROSPECTUS, OFFERING MEMORANDUM AND MATERIAL CONTRACTS

The directors of the Hedge Fund, if organized as a corporation, or Hedge Fund manager or general partner, if organized as a trust or limited partnership, should approve in a formal meeting the prospectus, offering memorandum or other disclosure documents and all material contracts to be entered into by the Hedge Fund.

Initially material contracts would include:

- i. Articles of Incorporation, a Trust Agreement or a Limited Partnership Agreement;
- ii. Administration Agreement with the Hedge Fund’s Administrator;
- iii. Prime Brokerage Agreements with the Hedge Fund’s Prime Broker; and
- iv. Investment Management Agreement with the Hedge Fund manager.

The Hedge Fund’s prospectus or offering memorandum should provide disclosure to potential investors that is adequate for them to make an informed investment decision, including material risks, material aspects of the valuation methodology, liquidity and the investment objectives, strategy and restrictions. Marketing material should be in line with this information.

Canadian securities laws impose content requirements and disclosure standards on prospectuses and offering memoranda. Canadian securities laws also grant rights to investors in the event that they are given untrue or incomplete disclosure.

Supplemental disclosures should be made in respect of material changes in any of the above.

The directors should affirmatively take responsibility for the statements in the prospectus or offering memorandum. The directors should closely review the prospectus or offering memorandum and, as appropriate, consult with the Hedge Fund manager, administrator, prime broker, lawyers and auditors, with the aim of making adequate disclosure.



5.1.3 APPROPRIATE PROFESSIONAL ADVICE

In evaluating its organizational structure, the advice of lawyers and accountants with experience in the tax and financial services regulations relevant to Hedge Funds, the jurisdiction and rules applicable to the Hedge Fund manager and their investments should be sought.

5.1.4 DIRECTORS AND TRUSTEES

Other than Hedge Funds organized as trusts, ultimate responsibility for the Hedge Fund rests with the directors either of the Hedge Fund itself, if it is organised as a corporation, or of the Hedge Fund's corporate general partner, if organised as a limited partnership. Directors should consist of natural persons rather than corporate entities. The directors should have relevant standing and experience to allow them to discharge their fiduciary and other duties. The directors should be prepared to act in the interest of the investors.

Hedge Funds organized as trusts are controlled by a trustee or trustees. In Canada, the trustee is typically either a third party trust company, or with appropriate regulatory approval, the Hedge Fund manager. The governing trust document may divide responsibilities for administration of the trust between the trustee and the Hedge Fund Manager. The responsibilities outlined in this chapter for directors will fall on the trustee(s).

Directors should meet regularly in minuted meetings. Formal agendas and reports should be prepared in advance and the Hedge Fund manager should report on the Hedge Fund's strategy, performance and compliance with investment objectives. The directors should also periodically be presented with reports on the performance of all of the Hedge Fund's counterparties and service providers. Audited financial statements should be approved on an annual basis. Minutes should be retained at the Hedge Fund's registered office.

5.2 Independent Service Providers

The Hedge Fund should appoint relevant reputable and experienced service providers. The Hedge Fund's service providers and their proposed contracts with the Hedge Fund should be reviewed and approved by the directors. In addition, once these service providers have been appointed, the Hedge Fund should make appropriate and timely use of its service providers' resources and expertise. In addition to the Hedge Fund manager, among the service providers that the Hedge Fund should appoint and monitor, are an administrator, prime broker (where appropriate to its business), custodian (where separately required by law), auditors and lawyers.

It is important at the beginning of each relationship with a service provider that the Hedge Fund's requirements are identified and documented. Appropriate due diligence should be carried out, generally by the Hedge Fund manager or his professional advisers on the Hedge Fund's behalf, prior to starting the business relationship (which may include face-to-face meetings with and office visits to the service provider). Once service providers have been retained, the directors should take reasonable steps to ensure that they and the Hedge Fund manager monitor the performance of all service providers and ensure that there is regular communication.

The directors should ensure that all service providers (including the Hedge Fund manager) have standing and expertise appropriate to their function for the Hedge Fund.

5.2.1 HEDGE FUND ADMINISTRATOR

The Hedge Fund should select an administrator that has the experience and resources to provide satisfactory services to the Hedge Fund. Specifically, the administrator should have experience in accounting for and valuing the products traded by Hedge Funds with similar investment strategies.

Investors may establish contact with the Hedge Fund through the administrator. The directors should bear this investor relationship role in mind when appointing the Hedge Fund's administrator.



5.2.2 PRIME BROKER(S) AND CUSTODIAN(S)

The prime brokerage documentation typically will be highly complex and should be reviewed by a lawyer familiar with these arrangements. The directors should ensure that they and the Hedge Fund manager fully understand the prime brokerage arrangements and the risks inherent in it.

An independent custodian may be required in some jurisdictions, in which case, advice should be sought on the ability of the custodian to appoint the prime broker as a sub-custodian.

5.2.3 AUDITORS

The directors, working together with the administrator, should be able to provide timely audited accounts to investors annually. The Hedge Fund should retain appropriately qualified external auditors that have experience with Hedge Funds generally and are familiar with the specific types of trading and instruments contemplated by the Hedge Fund manager. The Hedge Fund's jurisdiction may also impose certain requirements with respect to auditors. The directors should annually review the engagement of the auditors.

5.2.4 LAWYERS

A Hedge Fund should appoint legal counsel in appropriate jurisdictions, including where the Hedge Fund is domiciled and where the Hedge Fund manager is located and operates.

5.2.5 HEDGE FUND MANAGER

The Hedge Fund manager's services should be governed by a written agreement that specifically sets out the investment restrictions and investment policies of the Hedge Fund (by cross-reference, if appropriate, to the Hedge Fund's offering document(s)), as well as the fees to be paid to the Hedge Fund manager. The Hedge Fund manager may need to monitor other service providers to the Hedge Fund, and, in order to maintain its reputation, the Hedge Fund manager should act as a service provider to the Hedge Fund rather than as its controller. This may be particularly important from a tax perspective.



6. Special Considerations for Creating and Managing a Hedge Fund of Funds (FOF) Business

Many of the sound practices for Hedge Fund managers found in the preceding five chapters are applicable to FOF managers. The purpose of this section is to review some of the additional considerations unique to FOF managers.

In addition to the following section, AIMA has produced, in conjunction with industry experts, a comprehensive review of specific issues concerning FOFs in “A Guide to Fund of Hedge Funds Management and Investment”, October 2002. This document is available on the AIMA website. The review also contains the results of a survey conducted by Capital Markets Risk Advisors (CMRA) addressing some of the key issues surrounding FOFs. Certain sections of that document have been included here.

In general, investors invest in FOFs because they provide:

- i. additional diversification;
- ii. comprehensive risk management;
- iii. underlying Hedge Fund manager due diligence;
- iv. access to closed Hedge Funds and certain Hedge Funds for which investors cannot meet the investment minimum by themselves; and
- v. handling of manager selection and asset allocation.

These advantages are partially offset by additional costs and fees associated with FOFs.

6.1 Investment Process and Portfolio Risk Management

FOF managers must perform due diligence on the underlying Hedge Fund managers. This due diligence should incorporate, but is not limited to, the following:

- i. understanding the characteristics of all of the instruments used in the underlying Hedge Fund manager’s strategy;
- ii. studying the nature and quality of the hedges;
- iii. studying the nature of the hedged and residual risks;
- iv. assessing the performance of the strategy under different stress scenarios;
- v. assessing the Hedge Fund manager’s risk monitoring and management processes;
- vi. assessing the expertise of the Hedge Fund manager in the instruments used, the opportunity being exploited, and the trading and hedging required;
- vii. examining the Hedge Fund Manager’s back office operations and the Hedge Fund’s net asset value calculation procedures;
- viii. contacting the administrator, prime broker and auditors to verify independent communications;
- ix. conducting interviews with the administrator, prime broker, accountant and auditor in order to confirm how position and performance data are generated and communicated;
- x. conducting credit, education and employment checks on the principals and key employees of the Hedge Fund manager; and
- xi. using any alternative sources of information available to perform due diligence on the Hedge Fund manager, such as external and internal traders and advisors.

An underlying Hedge Fund manager should have demonstrated the ability to manage its strategy through a range of market conditions over a reasonable period of time. It is important to seek successful underlying Hedge Fund managers with high integrity and an unwavering focus and



dedication to success. FOF managers will generally look at Hedge Fund managers with a good, longer term track record. Additionally, the track record of the underlying Hedge Fund manager prior to their becoming manager of the underlying Hedge Fund in question should be considered.

Where appropriate, select as the underlying Hedge Funds, those in which the key decision-makers have significant personal investment. Underlying Hedge Fund managers with a significant portion of their personal net worth invested in the Hedge Funds they manage will be motivated to perform in a manner consistent with the interests of their investors. In some cases, the FOF manager can secure commitments from the underlying Hedge Fund managers to provide a notice of intention to reduce their personal investment in their Hedge Fund.

6.2 Portfolio Management and Strategy Allocation

A FOF can offer more comprehensive diversification than any single manager Hedge Fund. By investing in a number of different Hedge Funds employing diverse strategies, a portfolio of Hedge Funds should provide more consistent returns with lower volatility or risk than any of its underlying Hedge Funds.

The FOF maximum capacity is related to rate of growth in assets, as opposed to the level of assets as in the case of the underlying Hedge Fund managers. The capacity of an underlying strategy should be assessed with reference to the size of the market in the instruments used in the strategy. Additional consideration should also be given to the breadth, depth and participation of alternate buyers/sellers of those instruments; the liquidity of the Hedge Fund's holdings compared to trading volumes in those instruments; and the ability of the Hedge Fund to trade without impacting the market.

FOFs investing in underlying Hedge Funds is a relatively liquidity constrained process. When many successful Hedge Funds have reached their capacity limitations, they either stop accepting new money or only accept money from existing investors. At any time, underlying Hedge Fund managers may be open, closed, “soft” closed (i.e. only taking money to replace redemptions from existing investors) or may re-open opportunistically. Investments typically can only be made monthly and in minimum subscription amounts. Redemptions in most cases can only be made monthly or quarterly with anywhere from 10 to 90 days’ notice. Redemptions often have redemption penalties in the first year of investment and Hedge Funds can have a lock-up period where redemptions are not possible. Some Hedge Funds also restrict the rate of investment or redemption. The FOF manager must therefore take into careful consideration the matching of liquidity of the underlying Hedge Funds with the FOF investor liquidity.

When managing the portfolio, the FOF manager must take into consideration that they may be constrained from allocating to or redeeming from the first preference. One way of dealing with investment constraints is to negotiate capacity reservations upfront when investing with a Hedge Fund manager.

FOF managers should establish long-term minimum and maximum strategy allocation bands and all buy and sell decisions should be implemented within these bands. As the opportunities in different strategies and market conditions change, target allocations may be amended accordingly.

6.3 Risk Management

Risk management begins with strong due diligence and portfolio construction processes and procedures.

The FOF portfolio should be analyzed in aggregate form to ensure there is no undue concentration by sector, capitalization or individual position.

Hedge Fund characteristics including correlation, volatility and performance should be calculated and reviewed frequently.

The FOF manager’s experience is required to evaluate the strategies employed by the various Hedge Fund managers and to establish the appropriate mix of strategies that make up the FOF.



Choosing Hedge Funds that make up an effectively non-correlated portfolio requires appropriate analysis and substantial due diligence.

Ongoing monitoring is also required on each underlying Hedge Fund to ensure performance objectives continue to be met. Monitoring activities should include the following:

- i. Daily: in extreme market conditions, constant monitoring of vulnerable strategies.
- ii. Weekly: weekly performance estimates from the underlying Hedge Funds wherever possible.
- iii. Monthly: monitor strategy environment conditions and risk/reward characteristics for each strategy; Hedge Fund manager, peer group, and strategy index returns; risk parameters pertinent to each Hedge Fund manager's strategy (leverage, concentration, duration); calls with Hedge Fund managers; Monte Carlo stress testing of portfolio; leverage, concentration and VaR data should be collected and compiled on Hedge Fund managers on a monthly basis. Leverage should be expressed consistently across strategies, as well as by strategy, according to the most appropriate methodology.

Risk should be monitored at the underlying Hedge Fund manager level, the strategy level, and the portfolio level.

- i. Risk should be monitored at the Hedge Fund manager level through the collection, compilation, and analysis of monthly risk reports. These reports can then be used to compare Hedge Fund manager risk limits with the strategy peer group. Specific data on sensitivity to equity, interest rates and swap spreads (along the curve), credit spreads, equity and fixed income volatility should be collected.
- ii. Risk should be monitored at the strategy level through the tracking of market conditions that pertain to each strategy, Hedge Fund manager monthly reports and monitoring calls.
- iii. Risk should be monitored at the FOF level by risk analysis on the portfolio with every new allocation, effectively on a monthly basis.

In addition, a worst-case scenario may be assumed on a more subjective basis. Hedge Fund managers are surveyed to generate their portfolio response to shocks in equity, fixed income, credit and volatility markets. Hedge Fund manager responses are compared to their historic performance and monthly risk reports and may substitute higher draw down estimates. Then, the worst-case result for each Hedge Fund manager is assumed to happen concurrently, without intra-strategy offsetting results, and a worst-case draw down estimate is generated for the portfolio. Given the result, certain strategy exposures may be adjusted.

6.4 Benchmarking

The performance of the underlying Hedge Funds within a strategy should be monitored relative to the indices or peer groups most relevant to the strategy in question. These indices should be identified according to their consistency with the FOFs approach to the strategy.

Benchmarking strategies within a FOF remains a challenge because of the broad approach to risk even within underlying strategy groupings. If the strategy portfolio is under-performing its relevant index for reasons other than intentional differences, the portfolio and/or the strategy should be re-evaluated.

6.5 Reporting and Disclosure

In Canada, FOFs are required to prepare, publish and distribute semi-annual and annual audited financial statements to their investors. The FOF should also publish monthly unaudited results. The report should describe the month's significant events and provide updated statistics, including a breakdown of results by strategy.



6.6 Leverage

There are likely as many ways to calculate leverage as there are strategies in the Hedge Fund universe. Different Hedge Fund strategies have different ways of applying leverage, and what might be a prudent level of leverage in one strategy might be considered highly risky in another. It is important to understand leverage within each underlying Hedge Fund manager and strategy, and to assess leverage levels at the portfolio level. At a minimum, the FOF should collect monthly leverage data on a consistent basis from the underlying Hedge Fund managers. The Hedge Fund manager data can then be compared to the Hedge Fund manager's leverage limits, the peer group and the standard level of leverage appropriate for this strategy.

FOFs may employ additional leverage over and above that utilized by the underlying Hedge Fund managers. The FOF manager should clearly disclose the use of any additional leverage along with the risks and benefits to the FOF investor.

6.7 Transparency

The issue of transparency, both at the Hedge Fund manager and FOF level, has been the subject of industry debate. The CMRA survey referenced at the beginning of this section found that only 7% of FOFs had potential investors decline to invest because of lack of position level transparency. Investors are often more interested in "risk transparency" and in establishing that FOF managers have well-established, sound practices in risk management processes.

The FOF manager should be prepared to provide access to risk management practices and procedures in a way that is highly visible and accessible to investors, without undermining the proprietary nature of the underlying Hedge Fund or FOF activities. The FOF should be cognizant of setting up documentation and systems that allow for the production of reports on risk management on a timely basis.

6.8 Conflicts of Interest

Potential or perceived conflicts of interest can exist at the FOF level when:

- i. principals and employees of a FOF (or the FOF manager) invest directly in the underlying Hedge Fund;
- ii. different FOFs managed by the same FOF manager invest in the same underlying Hedge Funds;
or
- iii. management and/or performance fees are rebated to the FOF manager by the underlying Hedge Fund manager and the rebate is not passed on to investors.

These conflicts may arise because Hedge Funds typically have capital constraints. The difficulty in placing funds with or removing funds from a Hedge Fund manager may cause real or perceived advantages by those making these decisions when compared to the FOF investor.

A FOF manager can avoid these conflicts through the development of proper and consistent policies and proper disclosure to its investors.

6.9 Structured Products

The past ten years has seen the proliferation of Hedge Fund structured products designed to provide different types of investors with more attractive investment features. The structures are generally aimed at individual or institutional investors and focus on the different needs of those investors.

In Canada, structured products aimed at individual investors can have the advantages of lower investment minimums, tax related benefits and capital protection through principal guarantees. Institutional investors are more interested in how to allocate to hedge funds within the traditional



equity and fixed income baskets (portable alpha or overlay structures), capital protection/principal guarantees and to a lesser extent, foreign content limitations. Structured products have also been utilized to gain leveraged exposure to Hedge Funds and FOFs.

It is worthwhile for the Hedge Fund manager or FOF manager to investigate whether some of the available structures would be attractive given their target client base. Many legal and accounting firms in Canada are familiar with these structures. The Hedge Fund manager should take care in selecting these advisors and in selecting the counterparties and structures. These selections will have long-term implications on the ability of the Hedge Fund or FOF manager to successfully implement their business strategy, to attract new capital, and to provide the products in the manner intended. It is important to recognize that these structures all come at additional cost to the investor, and exposure to the credit worthiness of the counterparties.

Appendix 1 - Working Group

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Goldman Sachs (Prime Brokerage)

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Appendix 2 - Canadian Working Group

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Hillsdale Investment Management Inc
Maple Financial Alternative Investment
RBC Capital Markets
Torys LLP
York Hedge Fund Strategies Inc.

WITH THE HELP OF...

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The Bank of Nova Scotia
Blair Franklin Capital Partners Inc.
BluMont Capital Corporation
Deloitte & Touche Canada
Gowling Lafleur Henderson LLP
JCClark
McMillan Binch LLP
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