OSC Staff Notice 33-733

2010

Report on Focused Reviews of Investment Funds, September 2008 – September 2009

Contents

Executive summary **4**

Background **7**

Overview of the focused reviews **10**

1. Phase one – money market funds **14**

1.1 Compliance with NI 81-102 restrictions 14

1.2 Portfolio holdings 15

1.3 Redemption risk 16

1.4 Valuation of portfolio securities 17

1.5 Change in fees and expenses 17

2. Phase two – non-conventional investment funds **19**

2.1 Response to the market turmoil 19

2.2 Counterparty, credit and financial sector exposure 20

2.3 Level and valuation of illiquid assets 20

2.4 Investor communication and continuous disclosure 21

3. Phase three – hedge funds **25**

3.1 Custody 25

3.2 Portfolio holdings 26

3.3 Leverage usage and monitoring 28

3.4 Prime broker / counterparty exposure 29

3.5 Monitoring of funds of hedge funds 30

3.6 Liquidity or viability issues 31

3.7 Fund valuation 32

3.8 Use of service providers 33

3.9 Offering document disclosure 34

3.10 Other regulatory compliance matters 36

3.11 Comparison of fund manager practices to best practices suggested by AIMA 36

Appendix A: Statistics on fund managers who completed our questionnaire and who received a site visit **37**

Appendix B: Hedge fund managers' practices against AIMA's suggested best practices **38**

Executive Summary

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Executive Summary

This report summarizes the compliance review work conducted by staff of the Compliance and Registrant Regulation Branch (Compliance Team) and the Investment Funds Branch of the Ontario Securities Commission (OSC) in response to concerns emerging from the market turmoil experienced by the global financial services industry. Beginning in September 2008, the Compliance Team and the Investment Funds Branch conducted extensive reviews through a three-phased approach, focusing on major segments of the Canadian investment fund industry, namely money market funds, non-conventional investment funds and hedge funds.

Our primary focus in all three phases was to assess fund managers' compliance with Ontario securities laws. We did not assess the merits of the investment products covered by our reviews. We gathered information about the funds' portfolio holdings, exposure to distressed and/or illiquid assets, valuation methodologies, and how the managers managed the risk of large redemptions during the market downturn.

This report summarizes the findings from our questionnaire responses and the observations from our on-site visits, and includes further reporting on our review of money market funds and non-conventional investment funds in more detail than was previously provided in OSC Staff Notice 33-732 *2009 Compliance Team Annual Report*. It also includes some suggested practices. We encourage fund managers to use this report as a self-assessment tool to strengthen their compliance with Ontario securities laws and to improve their systems of internal controls and supervision.

In phase one, the review of money market funds, our focus was to determine if Canadian money market funds faced issues similar to those faced by U.S. money market funds relating to exposure to financial institutions having financial difficulties, illiquid securities or redemption risk. We observed that during the review period all funds were able to meet redemption requests, no investments held by the funds defaulted or were written down, and most funds were in compliance with the securities laws regulating money market funds.

In phase two, we reviewed non-conventional investment funds which include open-end and closed-end funds listed and traded on the Toronto Stock Exchange (TSX). We observed that some of these funds adopted more protective investment strategies as a result of the market turmoil and maintained higher levels of cash. Some fund managers reorganized some of their

funds. Fund managers monitored redemption levels closely and provided additional disclosure to their investors on the impact of the market turmoil.

In phase three, we reviewed hedge funds which are sold primarily to high-net-worth individuals and institutional investors by way of an offering memorandum. We observed that hedge fund assets were held with independent custodians, fund portfolios were fairly liquid, well-diversified and securities were valued appropriately.

Despite the overall market downturn and its impact on the returns of many of these products during our review period, we did not observe any industry-wide compliance issues. We noted some instances of non-compliance during our on-site visits which we addressed separately with each individual fund manager.

Background

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Background

The global financial markets have experienced a period of market turmoil. The subprime mortgage crisis in the U.S., which began in the summer of 2007, is generally viewed as the triggering event. Due to a significant increase in the default and foreclosure rates for subprime mortgages, structured-finance products (such as mortgage-backed securities, asset-backed commercial paper (ABCP) and collateralized debt obligations (CDOs)) performed poorly. Investor confidence weakened, causing the resale market for some of these products to collapse and liquidity to evaporate. The weakening of the market for these products also led to valuation problems for those holding these products.

In Canada, the market turmoil led to the freezing of the then $35 billion market for non-bank sponsored ABCP in August 2007. Some retail mutual funds were invested in non-bank sponsored ABCP when it froze. Mutual fund managers or other related entities of these mutual funds voluntarily bought all of the frozen ABCP from the funds at par plus accrued interest. This ensured that retail mutual fund investors would not incur losses from these investments.[1]

The market turmoil continued into 2008 creating significant liquidity challenges. Balance sheets were under pressure as a result of the near shutdown of the securitization markets. Lending between banks came to a halt, essentially freezing the credit markets. With the near failure of Bear Stearns in the spring of 2008 and the collapse of Lehman Brothers in September of that year, broker-dealers became less willing to extend credit to their counterparties, including hedge funds. Also, in September 2008 a money market fund in the U.S. known as the Reserve Primary Fund "broke the buck". Some hedge funds were also put under redemption pressure and were forced to liquidate assets as financing terms tightened. As a group, beginning in late summer 2008, their performance deteriorated sharply which led to further investor redemptions.

In response to the concerns emerging from these market events, the OSC executed a three-phased review initiative to assess the impact of the market turmoil in major segments of the Canadian investment fund industry. The three phases focused on fund managers that manage (1) money market funds; (2) non-conventional investment funds; and (3) hedge funds.

Given the events affecting the money market fund industry in the U.S. and liquidity concerns over the short-term debt market, we initiated a focused review of Ontario-based money market funds in September 2008. Our focus, in phase one, was to determine if our money market funds faced

[1] The impact of market turmoil on non-bank sponsored ABCP and mutual funds was discussed in the CSA Consultation Paper - *Securities Regulatory Proposals Stemming from the 2007-08 Credit Market Turmoil and its Effect on the ABCP Market in Canada* dated October 2008.

issues similar to those faced by U.S. money market funds relating to exposure to financial institutions having financial difficulties, illiquid securities or redemption risk.

In phase two, we extended our work to non-conventional investment funds. Our initial concerns were liquidity, credit risk and counterparty risk stemming from the credit crisis.

In phase three, we focused on hedge funds. The hedge fund industry has become an increasingly important component of Ontario's capital markets. Hedge funds offer flexibility in investment style and diversification benefits to investors. These benefits may also bring challenges and risks which were magnified when the global markets came under tremendous pressure in the second half of 2008.

Overview of the focused reviews

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Overview of the focused reviews

The Compliance Team and the Investment Funds Branch began the market turmoil focused reviews in September 2008 and completed them in September 2009. We executed our work in a three-phased approach. In all three phases, we focused on funds that were offered to Ontario investors and managed by fund managers based in Ontario. Over the course of the year, we sent out approximately 200 questionnaires, conducted meetings with senior management of selected fund managers and executed 56 on-site visits. Appendix A summarizes information relating to the fund managers that completed the questionnaires and those that received a site visit.

The comments in this report relate only to our observations of those fund managers that completed our questionnaires and those that were subject to an on-site visit. These observations are also limited to the scope of our reviews.

Phase one – money market funds

Investors generally view money market funds as safe and liquid investment vehicles. Portfolios held by these funds are generally more liquid because money market funds in Canada are subject to a number of investment restrictions in National Instrument 81-102 *Mutual Funds* (NI 81-102). A common feature of money market funds in Canada is that they strive to maintain a constant net asset value (NAV) of $10. However, there is no guarantee that the NAV will remain at $10.

Phase one, the review of money market funds, began in September 2008. We sent a questionnaire to 50 fund managers offering open-ended mutual funds in Ontario. These 50 managers had money market fund assets under management of approximately $67 billion, representing approximately 93% of the total money market fund assets[2]. We risk-ranked the questionnaires and selected 18 fund managers that would receive an on-site visit. The period reviewed was from August 1, 2007 to September 19, 2008.

We also completed further follow-up work on the money market funds subsequent to the on-site visits. We sent a follow-up questionnaire in May 2009 to the same fund managers of money market funds to assess whether any material changes had occurred since our review in September 2008.

[2] Money market fund assets under management was $72 billion as at January 2009: Investment Funds Institute of Canada.

Phase two – non-conventional investment funds

The focus of phase two was non-conventional investment funds listed and traded on the TSX. These include split share companies[3], actively managed funds, index tracking funds and structured products based on credit related derivatives[4]. Non-conventional investment funds have some of the following characteristics:

- *Product complexity*. Because non-conventional investment funds are generally subject to fewer regulatory investment restrictions than conventional mutual funds, they are able to employ more complex investment strategies and use leverage.
- *Illiquid assets*. Some non-conventional investment funds may have significant exposure to illiquid assets, which can lead to valuation issues.
- *Market risk*. Volatile markets can affect exchange-traded investment funds by lowering the value of their portfolio holdings. The trading value of the investment fund's own units or shares can also be negatively affected.
- *Sector exposure.* Some funds may have significant exposure to the foreign financial sector, senior loan markets and mortgage-backed securities.
- *Redemption risk*. Most non-conventional investment funds allow an annual (or more frequent) redemption at NAV. The risk of arbitrage for these funds can be increased if the discount between NAV and the listed price of the securities widens.

Phase two, the review of non-conventional investment funds, began in October 2008. We sent questionnaires to 27 Ontario-based managers of non-conventional investment funds. These managers had assets under management of approximately $36 billion, representing 84% of the industry total[5]. Based on the information reported in the questionnaires, staff selected six fund managers that would receive an on-site visit. The period reviewed was from August 1, 2007 to September 30, 2008.

Our review of non-conventional investment funds also included continuous disclosure reviews of certain investment fund issuers that received our questionnaire but were not selected for an on-site visit. We also performed a review of disclosure provided by linked note issuers and monitored information provided in the media by non-conventional investment funds. This included reviewing press releases relating to non-conventional investment funds. We focused on announcements of

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[3] A split share company, for the purposes of our review, is an investment fund that acquires a fixed portfolio of securities and issues two classes of shares (preferred shares and capital shares) to investors.

[4] Structured products based on credit related derivatives, for the purposes of our review, are funds that invest in credit default securities or derivatives whose performance is based on credit events of specified issuers.

[5] Non-conventional fund assets under management, measured by market capitalization, was $43 billion as at March 2008: TMX Group.

any suspension of redemptions, deferrals of or reductions to expected distributions, re-organizations or credit rating downgrades.

Phase three – hedge funds

Hedge funds in Ontario are typically pooled funds that are sold primarily to sophisticated or high-net-worth investors by way of an offering memorandum. They are not subject to certain securities laws and are generally required to provide less disclosure to potential investors. They are also subject to fewer investment restrictions as compared to traditional mutual funds. Hedge fund managers, however, are subject to Ontario securities laws which require investment fund managers to exercise their duties honestly, in good faith and in the best interests of their investment funds and the investors who have invested their money in their funds.

Issues affecting hedge funds include:

- *Valuation*. Many hedge funds hold complex, over-the-counter or illiquid financial instruments. The valuation of these instruments can be difficult as they may not have a verifiable market value.
- *Leverage*. While hedge funds employ leverage with the objective of magnifying potential returns, the use of leverage also magnifies losses suffered by investors and lenders in the event that the hedge fund incurs losses. In addition, leverage magnifies fluctuations in securities prices.
- *Liquidity*. Some hedge funds may experience redemption pressure because of illiquid markets and limited credit.
- *Transparency.* Many hedge fund managers are reluctant to disclose their investment holdings for competitive reasons. This lack of transparency creates concerns as to whether investors have adequate information to assess the investment risks of a particular hedge fund.

The review of hedge funds began in February 2009. We sent a questionnaire to approximately 90 hedge fund managers in Ontario. After risk ranking the responses, we selected 32 fund managers for an on-site visit. The period reviewed was from July 1, 2007 to December 31, 2008. These fund managers managed 192 funds, totalling $16 billion in assets under management as at December 31, 2008. Of these funds, 93 funds, totalling $8.9 billion, were funds of hedge funds, and 99 funds, totalling $7.1 billion, were standalone funds.

1. Phase one – money market funds

Our review of money market funds focused on the following areas:

1.1 Compliance with NI 81-102 restrictions

1.2 Portfolio holdings

1.3 Redemption risk

1.4 Valuation of portfolio securities

1.5 Change in fees and expenses

1. Phase one – money market funds

1.1 Compliance with NI 81-102 restrictions

Securities laws require money market funds to restrict their investments to a diversified portfolio of short-term debt instruments of a specific credit quality.

Observations

- Most money market funds complied with the investment restrictions under section 1.1 of NI 81-102[6] and with the concentration restrictions under section 2.1 of NI 81-102[7]. Fund managers had adequate monitoring procedures to ensure compliance with these restrictions.
- Where fund managers outsourced their fund administrative functions to an external service provider, they generally had good oversight procedures over the service provider.
- We noted some instances of non-compliance with the dollar-weighted average term to maturity requirement and with the 10% concentration restriction under NI 81-102. The instances of non-compliance were not material and were addressed with each individual fund manager.

Suggested practices

- Perform daily monitoring of compliance with the investment restrictions and concentration restrictions under NI 81-102 as money market funds are bought and sold daily.
- Include bankers' acceptances and bearer deposit notes in monitoring concentration restrictions under NI 81-102.
- Develop appropriate procedures to identify non-compliance with the investment restrictions and concentration restrictions under NI 81-102.
- Fund managers should ensure that the portfolio managers:
  - are familiar with all applicable regulatory requirements
  - monitor compliance on a frequent basis
  - report any instances of non-compliance immediately to the fund manager
  - rectify any non-compliance immediately

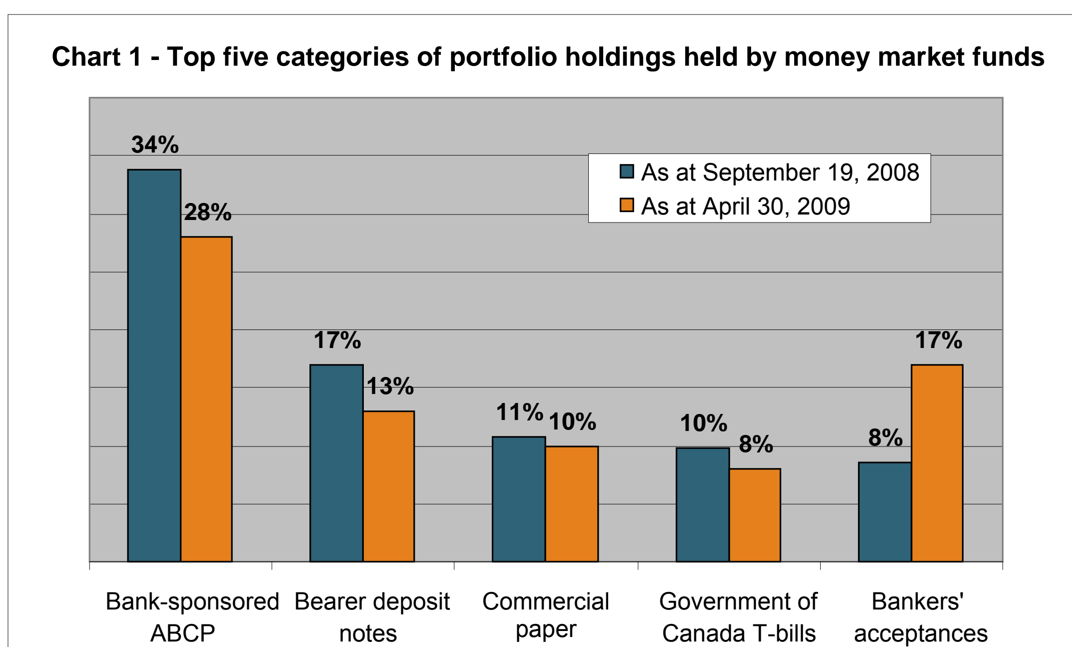
[6] Money market funds are required to comply with the investment restrictions under section 1.1 of NI 81-102, including (i) all of the assets must be invested in cash, cash equivalents, debt with a term to maturity of no more than 365 days and/or floating rate debt; (ii) dollar-weighted average term to maturity should not exceed 90 days; (iii) not less than 95% of the assets must be invested in the currency in which the NAV of the fund is calculated; and (iv) not less than 95% of the assets must be invested in cash, cash equivalents or evidence of indebtedness of issuers, provided that the commercial paper of the issuer has an approved credit rating.

[7] Under section 2.1 of NI 81-102, a mutual fund is prohibited from purchasing securities of an issuer if, after the purchase, more than 10% of its net assets would be invested in any one issuer.

1.2. Portfolio holdings

Observations

- Fund managers generally performed adequate and regular reviews of fund portfolios to ensure compliance with securities laws and with the funds' investment mandates.
- Chart 1 below shows the top five categories of portfolio holdings held by money market funds as at September 19, 2008 and April 30, 2009. The portfolio holdings are shown as a percentage of total portfolio holdings held by money market funds that completed our questionnaire. The top five categories of portfolio holdings as at April 30, 2009, based on responses from the follow-up questionnaire, did not change.



- Most funds were only exposed to Canadian issuers of money market securities. A small number of funds were also exposed to issuers in the U.S. and in Europe.
- None of the funds had exposure to illiquid assets.
- None of the fund managers wrote down any securities.
- The level of cash held in funds increased as a means to meet an increase in redemptions. In many cases, the term to maturity of the portfolios became shorter.
- ABCP held by the funds was bank-sponsored and had global-style liquidity support. Where the fund manager was also the portfolio manager, the fund manager performed adequate due diligence prior to investing in ABCP, and monitored the quality of the holdings on a continuous basis.

Suggested practices

- Monitor concentration risk by:
  - calculating and monitoring exposure to a single issuer at least on a daily basis
  - calculating exposure to a single issuer by including bank deposits with securities issued by that issuer
  - aggregating and monitoring exposure to an issuer and its related issuers
- Document procedures for monitoring credit quality of issuers, including:
  - frequency of review of credit ratings
  - procedures to deal with situations where inappropriate credit risk in a security or issuer is identified
  - ongoing credit monitoring procedures
  - record keeping (i.e. retain information to document the monitoring of credit risk)

1.3 Redemption risk

Observations

- Fund managers did not have issues in meeting redemption requests by fund investors. In addition, they did not foresee issues in meeting future redemption requests given the high level of liquidity of their portfolios.
- Fund managers put a number of mechanisms in place to manage redemption requests. We noted that:
  - fund managers generally maintained a more liquid portfolio and decreased the weighted average term to maturity of the fund portfolios
  - some fund managers monitored the holdings of individual unitholders so as to monitor the risk of having a single large unitholder redeem
  - some fund managers used a large unitholder agreement to restrict further purchases, to require a minimum holding period, or to require a longer notice period for a large redemption

Suggested practices

- Review daily sales and redemptions reports along with investments by maturity to manage cashflows effectively
- Monitor the holdings of individual unitholders to monitor the risk of having a single large unitholder redeem

1.4 Valuation of portfolio securities

Observations

- All fund managers valued their money market instruments in their money market funds at amortized cost, i.e. at cost plus accrued interest, based on their conclusion that amortized cost approximated fair market value.
- A number of fund managers also calculated the market value of their fund's portfolio which they compared to the amortized cost of the portfolio to confirm that amortized cost remained a valid approximation of fair market value.

Suggested practices

- Where amortized cost is used, ensure compliance with National Instrument 81-106 *Investment Fund Continuous Disclosure* (NI 81-106) which requires that the fund's portfolio be valued at market. The valuation of the fund's portfolio should be performed as often as the NAV of the fund is calculated.

1.5 Change in fees and expenses

Observations

- In light of the current low interest rate environment, nearly all of the fund managers reviewed had reduced or waived management fees and certain expenses to ensure that their money market funds continued to have a positive yield.
- Some managers chose to reduce trailer fees paid to dealers on money market funds held in the dealers' client accounts.
- Many fund managers disclosed the fee changes to their investors by issuing a press release, providing the information on the fund manager's website or filing an amendment to the fund's simplified prospectus.

Suggested practices

- Fund managers should ensure that information regarding fee changes is disclosed to their investors on a timely basis.
- Any waivers or absorptions of fees are required to be disclosed in the fund's financial statements and management reports of fund performance.

2. Phase two – non-conventional investment funds

Our review of non-conventional investment funds focused on the following areas:

2.1 Response to the market turmoil

2.2 Counterparty, credit and financial sector exposure

2.3 Level and valuation of illiquid assets

2.4 Investor communication and continuous disclosure

2. Phase two – non-conventional investment funds

2.1 Response to the market turmoil

Observations

- Fund managers monitored market conditions and assessed the impact on their funds on a continual basis. They worked with portfolio managers, dealers and other stakeholders in devising action plans aimed at protecting their funds, within the parameters of the constating documents of each fund. These plans included suspension of redemptions, decreases in distributions, equity offerings, rights offerings, changes to investment objectives and strategies, and fund mergers.
- Within the limits of each fund's investment restrictions, funds adopted more protective strategies, such as holding a higher proportion of the fund's portfolio in cash, or writing covered call options.
- Fund mergers were used to consolidate assets of non-conventional investment funds in order to provide unitholders with better liquidity and economies of scale. Some fund managers had different policies for mergers of non-conventional funds than for mergers of conventional funds that they also manage.
- Where an investment fund has a fund manager, administrator, portfolio manager, sub-advisors and valuation agent, the division of duties and obligations between them may overlap. In responding to the market turmoil, some fund managers needed additional time to determine which of the other service providers should be involved in particular decisions and to collect relevant information from them.

Suggested practices

- The investment restrictions followed by the fund are material information that investors use when making their investment decisions. Changes to the investment restrictions should be publicly disclosed in a timely manner.
- Fund managers should bear the cost of merging their non-conventional investment funds. While a fund merger may benefit unitholders, fund managers also benefit from mergers by maintaining assets under management. The policy rationale underlying the rules applicable to conventional mutual fund mergers applies equally, in staff's view, to mergers of non-conventional investment funds.
- When functions are delegated to third-party service providers, fund managers should maintain appropriate oversight and have the ability to review the accuracy and quality of the services provided in a timely manner. Even if delegating to service providers, fund managers

maintain the ultimate responsibility for the operations of the fund. Fund managers should always be aware of the issues affecting their funds, such as potential counterparty risks or the valuation of illiquid assets.

2.2 Counterparty, credit and financial sector exposure

Observations

- Some non-conventional investment funds were exposed to the foreign financial sector, certain debt markets (that were under stress) and complex credit derivatives, but this exposure was limited in comparison to the overall number and size of all non-conventional investment funds in the industry.
- Many structured products offered leverage exposure to the financial sector that was not expected to be volatile. The downturn in the financial sector had a severe impact on some of these structured products, which triggered protection events in favour of the debt holders, so that equity investors would be unable to participate in any future market recovery.
- Most of the non-conventional investment funds we reviewed were exposed to Canadian counterparties, which did not result in elevated counterparty risk. A small number of non-conventional investment funds were using foreign counterparties, but the level of exposure to the foreign entity was relatively small.

Suggested practices

- In addition to complying with the existing continuous disclosure requirements, managers of sector or specialized investment funds should provide updated and timely information to investors so that investors can understand and assess the impact of the market conditions to their fund. For example, for a complex investment structure, a sensitivity analysis may be helpful.

2.3 Level and valuation of illiquid assets

Observations

- Some funds invested a substantial portion of their assets in illiquid investments, creating liquidity issues and valuation issues. These funds were generally trading at a significant discount to their NAV, as investors made their own assessment of the value of the illiquid assets.

- Fund managers incorporated the market developments into their valuation methodology for illiquid assets, but not always to the same degree. For some illiquid securities, the changes in valuation did not fully reflect the overall change in value in the particular sector. In some cases, fund managers remained more optimistic about the future value of certain portfolio holdings.
- Some fund managers provided additional disclosure to investors regarding the level and valuation of illiquid assets in their fund.
- In at least one case, previous fund mergers resulted in the continuing fund facing challenges with respect to the combined level of illiquid assets.

Suggested practices

- The valuation of illiquid assets is inherently difficult and subject to numerous variables. Each NAV calculation should take into consideration all available information at the time the calculation is being made to properly reflect the fund's current value, not the manager's anticipation of the fund's value at a future point in time.

2.4 Investor communication and continuous disclosure

Observations – continuous disclosure reviews

- Fund managers were active in communicating with investors during the market turmoil. In most cases, the impact of the market turmoil was discussed in the funds' management report of fund performance.
- In addition to required regulatory filings, fund managers used their websites to update investors regarding the funds' investment exposure. One fund manager managing credit linked investment products used sensitivity analyses to show what the impact would be if certain credit events materialized.
- Investment funds based on credit related derivatives were generally structured as passive vehicles employing limited discretionary portfolio management. When these investment funds were under stress, fund managers responded differently. Most managers did not intervene to modify the fund's strategy. However, one fund manager actively implemented a defensive strategy by securitizing distribution payments in return for the ability of the fund to absorb further unfavourable credit events.

Observations – linked notes

- Linked notes had become increasingly popular and available to retail investors. However, these investments are usually complex and the exposure they offer can have features similar to certain embedded derivatives.
- Linked note issuers provided necessary information during the pre-clearance process.[8] However, as linked notes are not investment funds, they do not file financial statements and management reports of fund performance (they are included in the issuer's own disclosure filings). The primary source of continuous disclosure information specific to the linked note is the issuer's website.
- The impact of the market turmoil on the current value of the linked notes appeared to be in line with our expectations based on the underlying assets the notes were linked to.
- Linked notes have many key terms and conditions, including mitigating control features based on market disruption events. During the period of market turmoil, the interpretation of certain key terms was subject to additional scrutiny, raising questions of how certain linked note features should operate (for example, determining if a "market disruption event" had occurred which would trigger the need for an independent valuation agent).

Observations – media surveillance

- There was an increase in the number of press releases and filings during the period we examined.
- Many non-conventional investment funds announced that they were deferring or suspending scheduled distribution payments in order to preserve their net asset value. Some also gave advance notice that they would not be accepting redemption requests if they were close to an upcoming redemption date.
- Many non-conventional investment funds announced restructurings, including mergers, and capital raising initiatives (such as rights offerings). In addition to regulatory filings, fund managers were actively issuing press releases to clarify issues, including exposure to ABCP, specific investment exposure, as well as more details regarding material holdings of illiquid assets.

Suggested practices

- Information should be provided to investors in a manner designed to help them understand the impact of unusual market events on their investment. Fund managers should use their websites as effectively as possible to provide timely information to investors.

[8] See CSA Staff Notice 44-304 *Linked Notes Distributed Under Shelf Prospectus System* for a description of linked notes and the pre-clearance process.

- The interpretation and applicability of key terms and conditions of linked notes, such as the market disruption clause, knock-out and knock-in events, should be stated in a clear and easily understood manner so that investors can better understand when certain events will trigger each of them.

3. Phase three – hedge funds

Our review of hedge funds focused on the following areas:

3.1 Custody
3.2 Portfolio holdings
3.3 Leverage usage and monitoring
3.4 Prime broker / counterparty exposure
3.5 Monitoring of funds of hedge funds
3.6 Liquidity or viability issues
3.7 Fund valuation
3.8 Use of service providers
3.9 Offering document disclosure
3.10 Other regulatory compliance matters
3.11 Comparison of fund manager practices to best practices suggested by Alternative Investment Management Association (AIMA)

3. Phase three – hedge funds

3.1 Custody

Observations

- Fund portfolio assets were segregated and held with independent, reputable custodians. We verified the existence of fund assets by reviewing custodial statements on a sample basis and did not note any issues.
- Most fund managers performed reconciliations to the custodian's reported holdings on a regular basis.
- A few managers used the same bank account to process investors' transactions and corporate activities.

Suggested practices

- Maintain separate banking accounts to process investors' transactions and corporate activities. Effective September 28, 2009, section 14.6 of National Instrument 31-103 – *Registration Requirements and Exemptions* requires all registered firms to segregate and hold in trust client assets.
- Reconcile securities positions to the custodian's reported holdings on a regular basis. Follow up any discrepancies in a timely manner.

Other statistics

- 93% of the fund managers used a third-party custodian; 7% of the fund managers used an affiliate as the custodian.
- 95% of the fund managers used a member firm of Investment Industry Regulatory Organization of Canada for prime brokerage and custodial services.
- 75% of the fund managers used affiliates of Canadian Schedule 1 banks for prime brokerage and custodial services.
- The top four prime brokers and custodians used by the fund managers were affiliates of Canadian Schedule 1 banks.

3.2 Portfolio holdings

Observations

- The majority (83% based on assets under management) of the standalone hedge funds held a diversified portfolio (i.e. not more than 10% of the fund's net assets invested in any single holding).
- Hedge funds managed in Ontario had fairly liquid portfolios. The majority (91% based on assets under management) of the funds held less than 10% of the fund's net assets in private or illiquid holdings.
- Fund managers performed adequate and regular reviews of fund portfolios to ensure compliance with the funds' investment objectives, and to monitor portfolio risk and the liquidity level of each of their funds. A few large fund managers/portfolio managers also had an independent committee, separate from the portfolio management team, to oversee and manage portfolio risk and liquidity risk of the funds.
- Five hedge funds in our sample did not comply with the prohibited investment restrictions under subsection 111(2)(b) of the Act[9], which prohibits a mutual fund from making an investment in a company in which it is a substantial security holder. This subsection applies to hedge funds that meet the definition of a mutual fund under the *Securities Act* (Ontario).
- Six hedge fund managers, who were also the portfolio manager for their funds, did not comply with subsections 118(2)(a) and 118(2)(b) of the Act[10].
- Five hedge fund managers were providing investment advice without registration as a Portfolio Manager with the OSC.
- In each case of non-compliance with securities laws, we addressed the specific issues with the individual fund managers.

Suggested practices

- Have a strong and independent compliance function appropriate to the size and complexity of the operations. The individual(s) responsible for the compliance function should possess adequate regulatory knowledge and industry experience to establish and maintain a strong compliance system and to ensure compliance with securities laws.

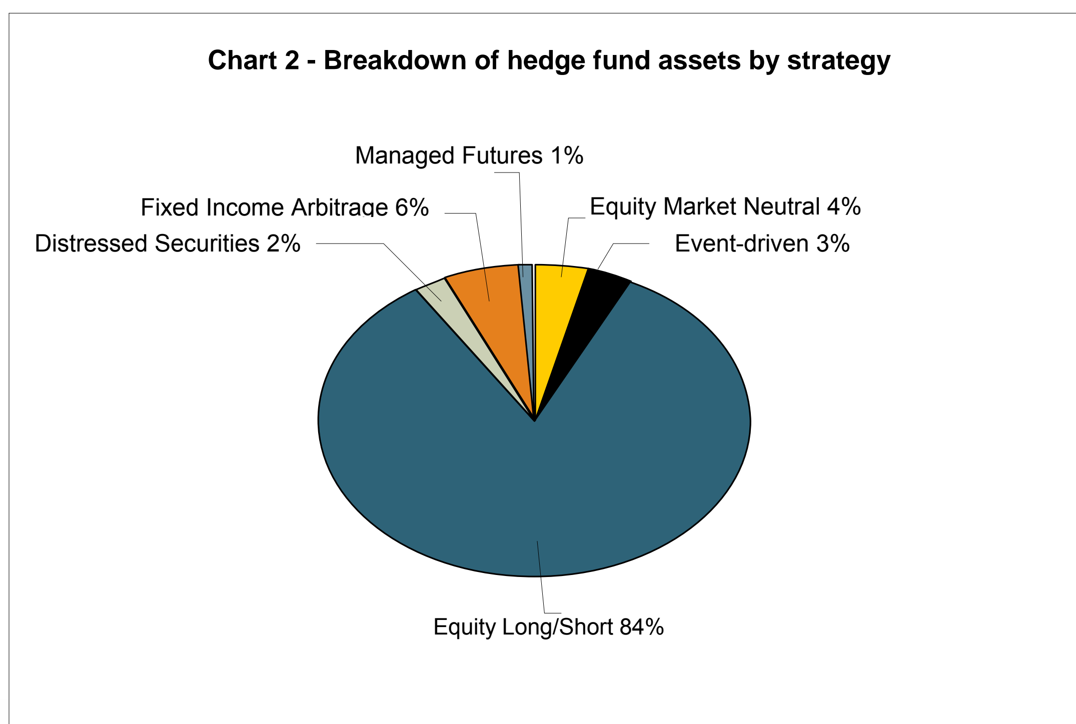
[9] Subsection 111(2)(b) of the Act prohibits a mutual fund from making an investment in any person or company in which the mutual fund, alone or together with one or more related mutual funds, is a substantial security holder, i.e. owning more than 20% of the voting securities.

[10] Subsection 118(2)(a) of the Act prohibited a portfolio manager from investing in an issuer in which a responsible person is an officer or director. Subsection 118(2)(b) of the Act prohibited a portfolio manager from cross trading between two accounts. With the implementation of National Instrument 31-103 – *Registration Requirements and Exemptions* (NI 31-103), section 118 of the Act was repealed. Section 13.5 of NI 31-103 contains prohibitions on certain managed account transactions and captures the same type of transactions that were prohibited under section 118 of the Act.

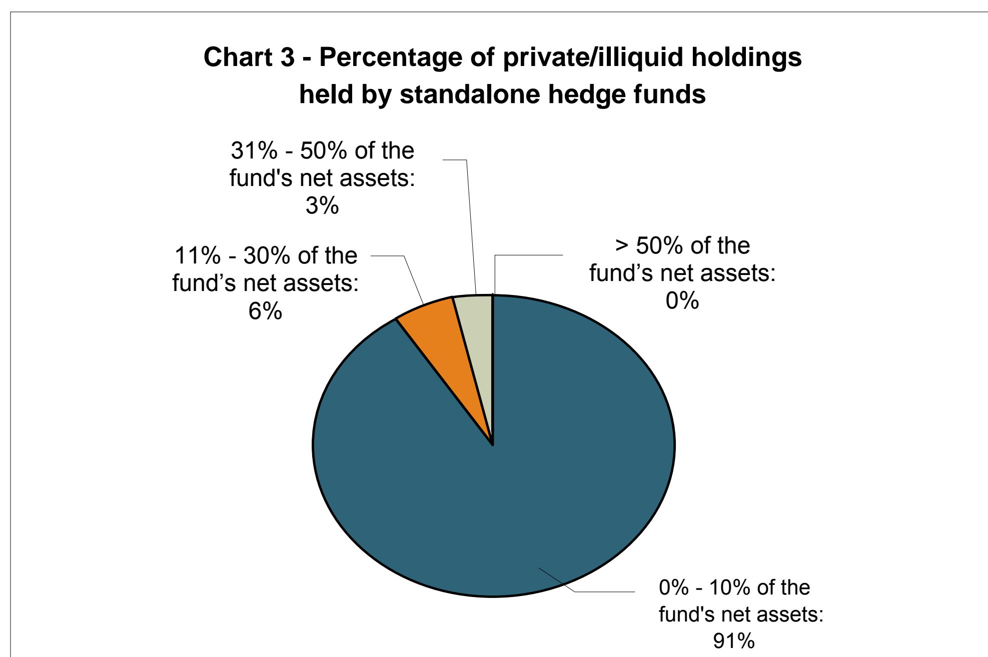
- Develop policies and procedures to prevent and detect conflicts of interest. Such policies and procedures should include, but are not limited to:
  - review ownership percentage in each investment held by a hedge fund on a regular basis
  - monitor outside business activities of responsible persons and their associates and create a list of related issuers that the funds cannot invest in
  - prohibit cross trading between accounts of a responsible person, an associate of a responsible person or the portfolio manager
  - have officers and directors sign an undertaking to report their holdings

Other statistics

- The majority (81%) of the hedge fund managers (or their affiliates) were also the portfolio manager to their funds.
- The majority (75%) of the hedge fund managers (or their affiliates) were also the distributor of their funds.
- Funds of hedge funds represented about 42% of total hedge fund assets.
- Two funds had a combined exposure of $8 million to Madoff, which was a large ponzi scheme uncovered in the U.S.
- Equity long/short strategy dominated our marketplace. Chart 2 below shows a breakdown by strategy of the standalone hedge fund assets as at December 31, 2008.



- Chart 3 illustrates the percentage of the funds' net assets invested in private or illiquid holdings as at December 31, 2008. For example, 3% of the funds reviewed (based on net assets) held between 31% to 50% of their net assets in private or illiquid holdings.



3.3 Leverage usage and monitoring

As with the other statistics in this report, we reviewed the use of leverage at a specific point in time (December 31, 2008). We did not collect data on leverage embedded in derivatives or underlying investments held by hedge funds.

Observations

- Hedge funds borrowed from prime brokers on a collateralized basis through margining, short selling and use of credit facilities. The level of borrowing is often quoted as a ratio of assets to capital or equity (e.g. 3: 1 or 3 times capital)[11].
- We observed that the majority of hedge funds employed a very low level of borrowing (1 to 1.1 times capital) as at December 31, 2008. This finding represented a snapshot at a point in

[11] There are several ways borrowing is measured in the industry. Some common measures are:
- gross market exposure, measured by the total of long and short positions, divided by capital
- net market exposure, measured by long positions less short positions, divided by capital

The majority of the fund managers quoted borrowing on a gross market exposure basis.

time and appeared to be consistent with the tight lending conditions and general conservative investment style at that time.

- As at December 31, 2008, the highest level of borrowing was 12 times capital. This represented about 1% of the hedge fund assets.
- We observed that fund managers had adequate monitoring procedures over the level of leverage of their funds. This included daily or weekly reviews of fund valuation, leverage calculations and margin reports from prime brokers.

Suggested practices

- Monitor leverage level regularly. Depending on the level of leverage, this may require daily or weekly monitoring.
- Stress tests should be done to assess the appropriateness of the level of leverage under both normal and exceptional circumstances (for example, an increased level of redemptions, drop in market values, changing spreads).

3.4 Prime broker / counterparty exposure

Observations

- The majority of the fund managers used prime brokers that are affiliates of Canadian Schedule 1 banks.
- The majority of the hedge fund managers used counterparties that are major banks in Canada or the U.S.
- Most fund managers monitored the creditworthiness of their counterparties informally. Some fund managers had formal procedures in place to monitor their counterparty exposure. Procedures included setting a minimum credit rating requirement, monitoring the credit rating of counterparties on a regular basis, and reviewing aggregate exposure to each counterparty.

Suggested practices

- Monitor, on a regular basis, the financial stability and credit risk of all counterparties including prime brokers by assessing the fund's aggregate exposure to each counterparty regularly, checking the credit rating of counterparties regularly, and maintaining regular contact with the counterparties.
- Diversify counterparty risk, where possible.

3.5 Monitoring of funds of hedge funds

This section relates only to those fund managers who were also acting as the portfolio manager.

Observations

- The majority of the fund of hedge fund managers performed adequate due diligence before making an investment in an underlying hedge fund. We observed fund managers having well-documented and traceable procedures for selecting underlying hedge funds based on both qualitative and quantitative characteristics of the funds and the fund manager.
- The majority of the fund managers received an in-person meeting with the underlying fund manager. They reviewed the most recent audited financial statements of the underlying fund and made appropriate enquiries in considering whether the liquidity level of the underlying fund was appropriate and sufficient for the fund of hedge funds to meet its redemption obligations.
- Some fund managers would only invest in an underlying hedge fund if an external fund administrator performed the valuation function.
- The majority of the fund of hedge fund managers had regular communication (usually weekly) with the underlying fund managers to evaluate fund performance, portfolio composition and the financial condition of the underlying funds.
- Some fund of hedge fund managers did not have full transparency of the underlying fund holdings at any time. Some managers only had full transparency on an infrequent basis.

Suggested practices

- Before making an investment decision, a fund of hedge fund manager should make reasonable enquiries to ensure that:
  - the underlying portfolio manager possesses adequate expertise, experience and qualifications
  - assets of the underlying fund are held by an independent, reputable custodian
  - the underlying fund is audited by an independent, reputable auditor at least annually
  - the underlying fund manager has well-established systems and controls in place to administer their funds. If any functions are outsourced to a service provider, assess that there is adequate oversight of the service provider
  - the valuation function is performed independently
  - the underlying fund manager will provide adequate information on the fund's activities on

  - a regular basis; this information should include information on fund holdings, leverage level, financial results, and significant events
  - the liquidity level of the underlying fund is appropriate and sufficient for the fund of hedge funds to meet its redemption obligations
  - it has considered the liquidity of the types of instruments held by the underlying fund and is aware of any limitations on redemption privileges that can be imposed by the underlying fund manager
- Document due diligence performed when selecting the underlying hedge funds.
- Obtain and review the most recent audited financial statements of the underlying funds prior to investing. Subsequent to that, obtain and review the audited financial statements at least annually.
- Have full transparency of the underlying fund holdings at all times in order to manage the fund portfolio and assess risks at the aggregate fund level.
- Collect leverage information from each underlying fund and assess overall leverage at the portfolio level.

3.6 Liquidity or viability issues

Observations

- Most fund managers increased cash balances during the market turmoil in anticipation of heavier than normal redemptions. This, along with the low percentage in private or illiquid holdings in general (as noted under Portfolio Holdings section above), enabled most fund managers to not have to exercise their right to suspend redemptions.
- Redemption restrictions imposed by the fund managers in our sample were carried out as permitted by the funds' offering documents. We did not note any incidences where preferential treatment was given to some unitholders allowing them to redeem their holdings prior to the fund manager deciding to suspend or restrict redemptions of a fund.
- Fund managers took appropriate steps to distribute assets of funds that were in the process of winding up in an equitable manner.

Suggested practices

- Monitor unitholder activities and liquidity requirements on a regular basis
- Communicate major events to investors in a timely manner
- Consider the interests of all unitholders when dealing with redemption requests

Other statistics

- 21 (0.9% based on assets under management) hedge funds had been wound up or were in the process of winding up, primarily as a result of market conditions.
- 16 (0.7% based on assets under management) hedge funds suspended redemptions during our review period. 12 (0.5% based on assets under management) of those that suspended redemptions were in the process of winding up during our review period.

3.7 Fund valuation

Observations

- The majority of fund managers used an independent third-party service provider to perform the valuation function.
- We observed fund managers using appropriate valuation methodologies to value portfolio securities. They applied their valuation methodologies consistently, and maintained adequate documentation to support any manually-priced securities and write-downs.
- Fund managers reviewed pricing of hard-to-value securities frequently (usually weekly) to determine if a revaluation was warranted. Some fund managers had individuals who were independent of the portfolio management function (for example, an independent valuation committee or a compliance officer) review and approve securities revaluation.
- Some fund managers valued restricted stocks at the market value of the freely traded underlying stock price and failed to apply a discount to reflect the illiquidity of these investments.
- Some fund managers valued warrants at the intrinsic value rather than the fair value. These fund managers did not have a process in place to ensure that the intrinsic value and the fair value were not materially different.
- Some fund managers did not have adequate written policies and procedures in the following areas:
  - valuation methodologies and processes to be followed for private, illiquid or restricted securities
  - processes for making manual price adjustments
  - review and approval processes for NAV calculations
  - processes to rectify NAV errors

Suggested practices

- Develop and implement written policies and procedures that include, at a minimum, the following:
  - valuation methodologies for all types of securities held in the funds' portfolios
  - valuation processes for securities that do not have readily available market prices
  - procedures to review and approve each NAV calculation, and to detect non-compliance with internal guidelines
  - procedures to investigate price variances over a pre-determined tolerance level
  - procedures for the identification, rectification and accounting treatment for NAV errors
- Disclose valuation policies and procedures, the role of third parties, and procedures for mitigating potential conflicts of interest during valuation.
- Apply valuation policies and procedures consistently.
- For hard-to-value securities, the fund manager may be involved in pricing the securities. The fund manager should provide the external fund administrator with sufficient supporting documentation.
- Ensure that responsibilities between the portfolio management function and the valuation function are segregated.
- Where it is necessary to use estimates in a fund of hedge fund structure to calculate NAV, develop appropriate procedures to review and adjust the NAV for any differences between the actual and the estimated NAV of the underlying funds.

3.8 Use of service providers

Observations

- The majority of the fund managers used a third-party fund administrator to perform administrative functions, including fund valuation. These fund managers maintained adequate controls over key functions, and adequate oversight over their service providers. They reviewed NAV calculations, fee calculations and reconciliations prepared by their service provider, and reconciled their own records with those of the service provider.
- Some fund managers did not maintain adequate books and records evidencing their oversight of the service provider. They did not maintain evidence of review or approval of NAV calculations, fee calculations and reconciliations prepared by the service provider.
- Three fund managers delegated their fund administration responsibility to a service provider but did not enter into a written service level agreement outlining the roles and responsibilities of the service provider in administering their funds.

Suggested practices

- Fund managers should maintain appropriate oversight and have the ability to review the accuracy and quality of the services provided in a timely manner. Even if delegating to service providers, fund managers maintain the ultimate responsibility for the operations of the fund.
- Enter into agreements that clearly outline the service providers' roles and responsibilities.
- Review service providers' processes, information flows, NAV and fee calculations, and ensure that adequate operational controls are maintained by the service providers.
- When the valuation of certain instruments can only be done by the manager, it is important that the external fund administrator also maintains documentation supporting the valuation.
- Assess service quality of all service providers at least annually, considering issues encountered and errors made by the service providers.
- Establish guidelines on how to monitor each outsourced function. This would include the types and frequency of reports to be provided by service providers, the types of issues that should be escalated to the fund manager; maintain evidence of the reviews of the outsourced functions.
- Maintain effective internal controls, checks and balances and segregation of duties. For example, require dual signatures to approve significant transactions, and reconcile cash and securities positions to the service provider's records regularly.

3.9 Offering document disclosure

Hedge funds are sold primarily to high-net-worth individuals and institutional investors by way of an offering memorandum.

Observations

- Overall, hedge fund managers in our sample provided adequate and clear disclosure in their funds' offering documents in most areas, except as noted below:
  - six fund managers did not adequately disclose risk factors associated with investing in their funds, including:
    - counterparty risk
    - credit risk
    - interest rate risk

    - risk of using derivatives
    - risk of using leverage
  - five fund managers did not fully disclose the fees and expenses incurred by their funds, including:
    - personnel and office space expenses
    - administrative fees
    - legal, audit and custodian fees
  - five fund managers did not disclose the material contracts they entered into on behalf of their funds, including with service providers
  - seven fund managers provided inconsistent, incorrect or outdated information in the offering documents of their funds

Suggested practices

- Fund managers should disclose all material information consistently and accurately in the fund's offering document. Such information should include, at a minimum, the following:
  - investment objectives, strategies and restrictions, including the use of leverage and derivatives
  - material risk factors
  - valuation policies and procedures
  - types of fees and expenses incurred by the fund
  - material contracts, including the use of service providers
  - conflicts of interest and procedures to identify and address them
  - subscription and redemption policies
- Fund managers should provide investors with adequate information throughout the life of their investment to allow them to monitor the investment over time. Such information should include, at a minimum, the following:
  - semi-annual and annual financial statements
  - periodic performance information
  - regular investor communication, reporting on significant events, any changes in the fund's risk profile, etc.

3.10 Other regulatory compliance matters

- Four fund managers distributed units of their hedge funds without being registered as an Exempt Market Dealer (formally Limited Market Dealer) with the OSC. Firms that are in the business of distributing hedge fund securities pursuant to a prospectus exemption must be registered as an Exempt Market Dealer.
- If the hedge fund meets the definition of a mutual fund, NI 81-106, which contains continuous disclosure requirements, applies. Sections 2.1 and 2.3 of NI 81-106 describe the filing requirements, and section 2.11 exempts certain funds from these filing requirements if certain criteria are met. One of these criteria requires the delivery of the fund's financial statements to unitholders within a specified time period. Six hedge fund managers did not deliver the annual and semi-annual financial statements of their funds to their unitholders within 90 days after the year-end and within 60 days after the end of a semi-annual period. These instances of non-compliance were addressed with each individual fund manager.

3.11 Comparison of fund manager practices to best practices suggested by Alternative Investment Management Association (AIMA)

AIMA published *Guide to Sound Practices for Hedge Fund Administrators* in September 2009. We compared the practices of the fund managers visited against some of the key suggested best practices by AIMA. The results are shown in Appendix B.

Appendix A: Statistics on fund managers who completed our questionnaire and who received a site visit

	Information gathering stage	Site visit stage	% visited
Money market funds			
No. of fund managers	36[12]	18	50%
Total net assets[13]	$67 billion	$63 billion	94%
No. of money market funds	89	61	69%
Non-conventional investment funds			
No. of fund managers	27	6	22%
Total market capitalization [14]	$36 billion	$23 billion	64%
No. of non-conventional investment funds	265	99	37%
Hedge funds			
No. of fund managers	88	32	36%
Total net assets[15]	$26 billion	$16 billion	62%
Total net assets with Ontario investors[16]	$8.4 billion	$6 billion	71%
No. of hedge funds[17]	312	192	62%
No. of hedge funds with Ontario investors[18]	233	132	57%

[12] 50 fund managers received our questionnaire, but only 36 of them managed money market fund(s).
[13] As at September 19, 2008.
[14] Total market capitalization as at March 2008: TMX Group.
[15] This represents the total net assets of the hedge funds managed by the hedge fund managers as at December 31, 2008, which includes fund assets held by Canadians and non-Canadians.
[16] This represents the portion of total net assets held by Ontario investors as at December 31, 2008.
[17] This represents the total number of hedge funds managed by the hedge fund managers as at December 31, 2008, which includes funds offered to Canadians and non-Canadians.
[18] This represents the number of hedge funds with investors residing in Ontario.

Appendix B: Hedge fund managers' practices against AIMA's suggested best practices[19]

Legend
○ performed by more than 70% of hedge fund managers
● performed by 50-70% of hedge fund managers
◙ performed by less than 50% of hedge fund managers

AIMA's key suggested best practices	Hedge fund managers visited
Have an independent valuation function, or have adequate segregation of duties between the valuation function and the investment management function.	○
Have a detailed valuation policy document, approved by the governing body, which is usually the board of directors, or the general partner.	●
Apply the valuation policy consistently. Any deviations from the policy should be approved by the governing body.	○
Use multiple price sources to verify the valuation of a fund's portfolio.	●
Any pricing models used by the fund manager should be independently tested and verified.	◙
Accrue fund expenses accurately and on a timely basis in order to strike an accurate NAV.	○
Reconcile cash and securities positions to prime broker or custodian statements.	○
Set out clearly the roles and responsibilities of the fund administrator in an administration agreement and/or a service level agreement.	○
Choose a fund administrator that can offer the necessary technology and staff expertise to support the fund's operating model.	○
Ensure that all fund offering documents are accurate and disclose all relevant information, including the role of the administrator, valuation provisions and subscription/redemption procedures.	●
Disclose the party who performs the NAV calculation function.	●

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[19] Alternative Investment Management Association, Guide to Sound Practices for Hedge Fund Administrators, September 2009.

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As the regulatory body responsible for overseeing the capital markets in Ontario, the Ontario Securities Commission administers and enforces the provincial Securities Act, the provincial Commodity Futures Act and administers certain provisions of the provincial Business Corporations Act. The OSC is a self-funded Crown corporation accountable to the Ontario Legislature through the Minister of Finance.