



MANAGED FUNDS ASSOCIATION

June 29, 2007

British Columbia Securities Commission
Alberta Securities Commission
Saskatchewan Financial Services Commission
Manitoba Securities Commission
Ontario Securities Commission
Autorité des marchés financiers
New Brunswick Securities Commission
Register of Securities, Prince Edward Island
Nova Scotia Securities Commission
Superintendent of Securities, Newfoundland and Labrador
Register of Securities, Northwest Territories
Register of Securities, Yukon Territory
Register of Securities, Nunavut

c/o Mr. John Stevenson
Secretary
Ontario Securities Commission
20 Queen Street West, 19th Floor, Box 55
Toronto, Ontario M5H 3S8
Fax: (416) 593-2318
jstevenson@osc.gov.on.ca

Anne-Marie Beaudoin
Directrice du secretariat
Autorité des marchés financiers
Tour de la Bourse
800, square Victoria C.P. 246, 22 étage
Montréal, Québec H4Z 1G3
Fax: (514) 864-8381
consultation-en-cours@lautorite.qc.ca

Re: Comments on Proposed National Instrument 31-103 – Registration Requirements

Dear Sirs / Mesdames,

Managed Funds Association (“MFA”) appreciates the opportunity to make this submission of comments in response to Proposed National Instrument 31-103 – *Registration Requirements* (“NI31-103”) issued for comment on February 23, 2007.

MFA is the voice of the global alternative investment industry. Its members include professionals in hedge funds, funds of funds and managed futures funds. Established in 1991, MFA is the primary source of information for policymakers and the media and the leading advocate for sound business practices and industry growth. MFA members represent the vast

majority of the largest hedge fund groups in the world who manage a substantial portion of the over US\$1.5 trillion invested in absolute return strategies.

MFA is dedicated to enhancing the understanding of the hedge fund industry, fostering dialogue with regulatory authorities and otherwise improving communications about the alternative investment industry. MFA activities include educational outreach to and representation before the U.S. Congress, U.S. Securities and Exchange Commission (“SEC”), U.S. Commodity Futures Trading Commission, Federal Reserve Board, U.S. Department of the Treasury, state legislatures and international regulatory agencies such as the Canadian Securities Administrators (“CSA”).

INTRODUCTION

Hedge funds are important and prominent participants in today’s global financial marketplace. As recognized by the President’s Working Group on Financial Markets (“PWG”), these “private pools of capital bring significant benefits to the financial markets,”¹ and are an “essential part of what keeps our capital markets the most competitive in the world.”² Some of the important benefits that hedge funds bring to the capital markets include “liquidity, price efficiency and risk distribution.”³

MFA members participate in the Canadian capital markets by providing sophisticated Canadian investors with alternative investment opportunities, raising capital for their funds in Canada and investing in or trading in the securities of Canadian companies. Therefore, MFA has a strong interest in NI31-103 and its potential impact on the activities of U.S. and international hedge funds and other alternative investment vehicles in the Canadian market.

Earlier this year we met with regulators from the Ontario Securities Commission (“OSC”) who indicated, that it was helpful to understand the regulatory regime applicable to hedge funds in the U.S. and other major markets, when developing Canadian rules. Thus, in case the CSA may find it helpful, we have attached as Appendix “A” a more detailed overview of the U.S. regulation of hedge funds.

I OVERVIEW OF HEDGE FUND INDUSTRY

A hedge fund broadly refers to a privately offered fund that is administered by a professional investment management firm (*i.e.*, hedge fund managers). The term “hedge fund” is not a defined term under the U.S. federal securities laws, but it is used generally to connote a private investment fund that is not required to register as an investment company under the U.S.

¹ President’s Working Group on Financial Markets, *Agreement Among PWG and U.S. Agency Principals on Principles and Guidelines Regarding Private Pools of Capital* (Feb. 22, 2007) (“Statement on Private Pools of Capital”), available at: <http://www.treasury.gov/press/releases/reports/principles.pdf>.

² Remarks of Under Secretary for Domestic Finance Robert K. Steel on Private Pools of Capital, U.S. Department of Treasury, Treasury Department Cash Room (Feb. 27, 2007) (hereinafter “Remarks of Under Secretary Steel”) available at: <http://www.treas.gov/press/releases/hp280.htm>.

³ Testimony of the Honorable Randal K. Quarles, Under Secretary for Domestic Finance, U.S. Department of the Treasury, Before the Senate Committee on Banking, Housing and Urban Affairs, page 2 (July 25, 2006).



Investment Company Act of 1940 (the “Investment Company Act”). Hedge funds are one category of the universe of “alternative investments”. Other categories include: venture capital, private equity, leveraged buyout, oil and gas, and real estate funds. The distinctions among these different types of funds are becoming more blurred as they engage in many of the strategies traditionally employed by the other types of funds, such as hedging, venture capital, distressed financing, and taking large activist positions. As investors continue to seek to invest in hedge funds for their diversification benefits and attractive risk-adjusted performance, these funds continue to diversify their investment strategies to meet the demands of investors. We do not believe that hedge funds are riskier than other types of private pools of capital, such as private equity funds or venture capital funds.

Because of the non-public nature of hedge funds, there is no universally accepted estimate on the size of the hedge fund industry. MFA believes the industry consists of over 13,000 single hedge funds, managed by approximately 4,900 distinct hedge fund managers, with total assets under management of over US\$1.5 trillion. Approximately 240 of these single hedge fund managers are large organizations, each of which has assets under management of at least US\$1 billion. It is estimated that these 240 managers collectively manage over 80% of all hedge fund assets. At the other end of the hedge fund spectrum, there are thousands of small firms managing hedge fund assets under US\$50 million each, many of them relative newcomers to the industry.

II DISTRIBUTION OF NON-CANADIAN HEDGE FUND SECURITIES IN CANADA

The level of capital raising activities by non-Canadian hedge funds in Canada has increased dramatically over the course of the last few years as a result of favorable Canadian regulatory developments. First, the elimination of the “foreign property” restrictions for Canadian pension plans and retirement plans has led Canadian investors to seek out alternative investments, including hedge funds, outside of Canada as a means to gain exposure to the international capital markets and access expertise not otherwise available in Canada. Second, the adoption of National Instrument 45-106 – *Prospectus and Registration Exemptions* (“NI 45-106”), which created a national (except Ontario, Newfoundland, Labrador and Yukon Territory) exempt market for trading with “accredited investors” has been important for Canadian investors in non-Canadian investment funds. Third, the decision by the OSC to permit non-resident dealers to register as “limited market dealers” has also provided greater access to the Ontario market by permitting such dealers to deal with accredited investors in Ontario.

Non-Canadian hedge funds generally distribute their securities to Canadian investors in reliance on “accredited investor” exemptions from the prospectus and dealer registration requirements which are available in all jurisdictions other than Ontario, Newfoundland and Labrador and the Yukon Territory (the “Non-Ontario Regime”). These exempt distributions of hedge fund securities must be reported to the relevant securities regulatory authority by filing an exempt trade report and, in several jurisdictions, a copy of the offering memorandum or other offering document delivered to the investor.

In Ontario, Newfoundland and Labrador (the “Ontario Regime”), hedge funds distribute their securities to accredited investors in reliance on the same prospectus exemption that applies under the Non-Ontario regime and with similar disclosure obligations, except the dealer registration exemption is not available to “market intermediaries” such as hedge fund managers.



As a result, a registered dealer must be involved in every distribution of hedge fund securities under the Ontario Regime.

Because the OSC takes the position that a hedge fund adviser has clients in Ontario if it advises a non-Canadian fund which has Ontario investors (the so called “flow-through” analysis), non-Canadian hedge fund advisers generally rely on exemptions from adviser registration currently available in Ontario, such as the exemption from adviser registration if the fund securities are sold through an Ontario registered dealer. The client flow-through approach creates additional complications for advisers to non-Canadian funds that invest in commodity futures, because non-resident exemptions from adviser registration are not generally available under the *Commodity Futures Act* (Ontario).

III COMMENTS ON NI31-103

We commend the CSA for its efforts in harmonizing and streamlining the Canadian registration regime, and believe that a national system will cut down on administrative costs borne by investors while still protecting them from fraud.

We are concerned, however, that NI31-103, as it applies to non-Canadian market participants, may cause a significant reversal and/or decline in non-Canadian investment diversification opportunities for Canadian investors. We are unaware of any major compliance/regulatory concerns regarding the participation of U.S. and international hedge funds in the Canadian marketplace that would call for drastic reform and believe that NI31-103 is really meant to address certain Canadian domestic concerns.

In particular, we are concerned about the CSA’s adoption of the client flow-through analysis to adviser registration and the elimination of the accredited investor exemption from dealer registration. We believe that NI31-103 as drafted will over-regulate international participants in the Canadian capital markets and negatively impact Canadian investors by significantly limiting access to non-Canadian investment opportunities.

3.1 “Flow-Through” Analysis

Based on various discussions and meetings MFA members have attended, we understand that the CSA will be eliminating the “flow-through” analysis from NI31-103 by revising the exemptions for international portfolio manager and international investment fund manager currently set out in sections 9.15 and 9.16. We strongly support the elimination of the flow-through analysis as we believe that it will benefit Canadian investors by eliminating the cost of an unnecessary intermediary, as further explained below. Otherwise, the flow-through analysis has meant that the “advisers” (broadly defined) to almost all U.S./international funds with Ontario investors needed to be registered as an adviser in Ontario or be exempt from adviser registration by selling fund units through an Ontario registered dealer. We believe the investor protection rationale for the client flow-through approach would be better served by raising the “accredited investor” standard, so that only sophisticated investors are able to subscribe for hedge fund securities on a prospectus and dealer registration exempt basis. A truly sophisticated investor does not need the protection of a registered broker-dealer or of the state when negotiating contracts or evaluating investment opportunities.



3.2 Dealer Intermediation of Exempt Market Trades

We believe that the requirement for U.S./international funds to use a registered dealer or to become a registered dealer to sell funds to accredited investors in Canada should be removed from NI31-103 (section 9.2 of NI31-103) as it raises costs for sophisticated investors without additional benefit. We recognize the concern about the “retailization” of fund investments intended for sophisticated investors, however, we believe that the solution is not to require a dealer to intermediate trades to accredited investors but instead to change the accredited investor definition so that only truly sophisticated investors qualify.

Our experience has been that highly sophisticated investors, such as pension funds, fund-of-funds and financial institutions resident in Ontario, generally, seek out non-Canadian hedge funds on their own or through the assistance of a hedge fund consultant, and not on the recommendation of a registered dealer. Once the sophisticated investor in Ontario decides to invest in a non-Canadian hedge fund, the non-resident fund must involve an Ontario registered dealer to intermediate the private placement. The registered dealer must then, among other things, satisfy know-your-client and suitability requirements with the investor, perform diligence on the fund (which from a practical perspective may be quite difficult for a dealer not otherwise involved in the investment) and negotiate a dealer agreement including fees and appropriate indemnities. For these sophisticated investors, the requirement for a dealer to intermediate the trade creates additional costs and complications without adding any value to the investment decision-making process.

In 2003, we submitted a White Paper to the SEC on increasing financial eligibility standards for investors in hedge funds.⁴ In that paper we stated:

“The Commission’s review, in part, apparently has been prompted by concern about the current popularity of hedge funds and whether they are now marketed to investors who are not sufficiently sophisticated to appreciate their risks. We understand the Commission’s concern that hedge fund products should be offered only to investors for whom such products are appropriate. Given that evaluating investments in pooled investment products such as hedge funds requires a significant degree of investment sophistication, if the Commission concludes that hedge funds are being marketed to investors who lack the requisite financial sophistication, it may wish to consider amending the definition of “accredited investor”...”⁵

Also, in that paper, we suggested amending the definition of accredited investor to increase the standards of financial eligibility for natural persons investing in pooled investment

⁴ *White Paper on Increasing Financial Eligibility Standards for Investors in Hedge Funds*. Managed Funds Association, July 7, 2003 (attached in pdf format).

⁵ *Supra* at p.1



vehicles to a net worth threshold of US\$2 million or annual income threshold of US\$400,000, and annual joint income threshold of US\$500,000.

Last December the SEC proposed to amend the accredited investor definition for investing in certain private investment vehicles. The proposed amendment would increase the monetary threshold for a natural person to invest in a private investment vehicle, such as a hedge fund, by requiring a natural person to meet the “accredited investor” net worth or income test and have US\$2.5 million in investments. We support the SEC’s efforts to raise the accredited investor standard, but recommended that rather than create a new “accredited natural person” definition the SEC simply raise the current accredited investor standard, by adjusting the net worth and income tests for inflation (approximately the same numbers as our 2003 recommendation), to prevent investor confusion.

We believe the current definition of accredited investor has become outdated due to inflation. The U.S. standards on which the Canadian definitions are based were established in 1982. Likewise, we encourage the CSA to adopt a more meaningful accredited investor definition, which captures only those entities and individuals with the sophistication to make informed investment decisions. We submit that when an accredited investor is truly a sophisticated investor, there is no need, nor value derived from requiring a registered dealer to intermediate a private placement between the investor and a private investment fund. Further, a sophisticated investor always has the option of electing to receive additional advice or guidance.

Recommendation

We recommend that the CSA adopt on a national basis the non-Ontario regime while increasing the financial eligibility requirements for investors to qualify as accredited investors. We also recommend that the CSA eliminate the need for a dealer to intermediate these transactions since there should be no investor protection concerns and as there are no benefits for sophisticated investors.

3.3 Transition/Grandfathering

We believe that it is extremely important for NI31-103 to contain clear and reasonable transitional provisions to minimize the financial burden experienced by investors and businesses if the CSA elects to narrow or eliminate current exemptive provisions used by foreign investment funds. For example, without a grandfather provision for existing Canadian investors in foreign funds, many Canadian clients may unexpectedly find that they need to be redeemed out of their foreign fund investments in order for the entities to comply with NI31-103. In addition, besides the legal impact of the regulatory changes, regulatory reform without grandfathering could negatively impact Canadian investors through significant tax consequences, and by raising new, interpretive contractual issues. We recommend that the CSA provide appropriate grandfather provisions in NI31-103 if it chooses to narrow or eliminate exemptive provisions used by foreign investment funds.



3.4 *Draft Legislation*

MFA submits that, due to the overall comprehensiveness of NI31-103, it would be beneficial to the review and comment process to be able to review draft legislative amendments as early in the process as possible.

CONCLUSION

We believe that in NI31-103 the CSA should adopt a dealer registration exemption for distributions to accredited investors (currently available in most provinces) on a national basis and should not adopt the “flow-through” analysis currently applied in Ontario; and that by raising the accredited investor standard, the CSA will address investor protection concerns and prevent the “retailization” of private hedge fund distributions. Furthermore, such an approach will be beneficial to sophisticated Canadian investors who will be able to access a wider and more diverse range of international investments. MFA submits that these main recommendations present a simpler regulatory approach while maintaining investor protection and investor options, and would be more consistent with the policy rationale for the exempt market system in Canada. We believe that the significant changes proposed in NI31-103 for offshore investment vehicles are not necessary to protect Canadian investors and would negatively impact Canadian investors by restricting investor options. We have long advocated raising the accredited investor standard in the U.S., and we have always supported protecting investors from fraud.

Furthermore, MFA supports mutual recognition of regulation in developed markets, especially the U.S., United Kingdom and European Union. MFA believes that there is no need for the CSA to regulate activities that are regulated or exempt in other well-developed capital markets and that the CSA should seek to harmonize or make its rules compatible with the regulatory regimes in those markets.

MFA appreciates the opportunity to comment on the CSA’s proposed NI31-103. We support the CSA’s efforts in promoting investor protection and creating a more efficient investment environment in Canada through streamlining, harmonizing and modernizing the Canadian registration regime. We hope that our comments will help ensure that any regulation promulgated is both effective and the least intrusive and burdensome as possible. We look forward to working with the CSA and would be pleased to meet with the CSA to discuss our comments or the hedge fund industry.

Respectfully submitted,



John G. Gainie
President

