Hedge Funds & Structured Products Bulletin

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AIMA Canada Releases the *Sound Practices Guide for Canadian Hedge Fund Managers*

The Canadian chapter of the Alternative Investment Management Association ("AIMA") has released its new "Sound Practices Guide for Canadian Hedge Fund Managers" (the "Guide"). AIMA Canada, which now has 50 corporate members, is part of a global non-profit organization based in London, England, with over 600 corporate members worldwide. AIMA's primary objectives are to increase investor education and transparency, promote due diligence and work with regulators to advance and monitor the use of alternative investments.

The Guide provides an overview of a number of issues relevant to managers of Canadian hedge funds, but is not intended to set out best practices for the industry. Managers of new hedge funds can use the Guide as a reference source of start-up issues to consider. Managers of established hedge funds can refer to the Guide in connection with a review of their existing operations and internal control mechanisms. Institutional investors can use the Guide to help identify operational risk areas and due diligence issues when assessing potential investments in hedge funds.

Highlights of the six main topics contained in the Guide are discussed below. The full text of the Guide is available on AIMA Canada's website at www.aima-canada.org.

I. Creating and Managing a Hedge Fund Business

Most hedge funds start out small and, as a result, employees are usually expected to perform a wide range of tasks. The hedge fund may rely on a number of external service providers, such as brokers, administrators, consultants, systems providers, accountants and lawyers. The Guide recommends that regardless of its size, each hedge fund should ensure it has appropriate systems, procedures and controls in place to mitigate and manage risks, including all non-investment risks associated with the fund.

The Guide also recommends that each fund should ensure that it: (a) has the appropriate finance systems, capable of developing budgets, monitoring financial resources, producing timely management accounting and financial information and providing the necessary regulatory financial reports in the required format; (b) takes reasonable steps to understand the regulatory environment and applicable compliance issues; and (c) recruits and trains employees to acquire and retain the requisite level of knowledge and expertise.

II. The Investment Process and Portfolio Risk Management

The Guide recommends that hedge fund managers develop a set of procedures to manage interaction with the market, including with respect to how investments are placed in the market and how controls operate before orders are executed. Managers should understand regulation relating to the principals of "best execution" and code of market conduct, ensure appropriate measures are taken if and when derivatives are used and be mindful of inducements and soft commissions and potential conflicts of interest. Hedge fund managers should also adopt a personal trading policy to effectively manage potential conflicts of interest between staff and investors.

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The investment process for hedge funds evolves over time. In order to reduce the risk of investing errors by staff and to avoid misunderstandings amongst investors, changes to a hedge fund's investment process should be effectively communicated and disclosed to staff members and investors on a timely basis. The Guide sets out specific suggestions for such documentation and communication.

The Guide recommends that each hedge fund manager develop a process to manage its level of risk. It is suggested that such a process should identify the risks inherent in the investment process, define the manager's attitude towards each risk and monitor the risk on a regular basis.

III. Portfolio Administration and Operational Controls

Since many hedge fund managers operate multiple hedge funds and separate managed accounts, the processes and controls should be consistent for each fund and account. In fact, Canadian regulators focus on the "review and testing of operational controls" for regulated hedge fund managers.

The Guide suggests hedge fund managers should maintain and follow an operational manual that sets out detailed procedures for the following: (i) trades; (ii) non-trading transactions; (iii) portfolio valuations; (iv) managing service providers; and (v) information systems and business continuity.

The Guide highlights that ultimately it is the hedge fund manager's responsibility to ensure compliance with proper operational procedures. Managers should document, monitor and review all operational procedures, irrespective of whether these procedures are undertaken internally or outsourced to an external service provider.

IV. Raising Capital and Investor Relations

Attracting investors and raising capital are key success factors for hedge funds. However, hedge fund managers must remain cognizant of applicable regulatory constraints. The Guide identifies issues for managers to consider when promoting their services and marketing their hedge funds such as anti-money laundering, anti-terrorism and adequate and timely disclosure requirements. The Guide also identifies regulatory considerations regarding promotion and marketing of hedge funds, targeting and attracting investors and special agreements with investors.

V. Hedge Fund Structure and Organization

In its recommendations, the Guide notes that the structure and organization of each hedge fund will vary depending on the nature and complexity of the investment strategy, products traded and the needs and preferences of its investors. Nonetheless, the Guide discusses the common structural and organizational issues for Canadian-domiciled hedge funds such as: (i) legal structure (i.e., limited partnership or trust); (ii) governing jurisdiction; (iii) tax considerations; (iv) listing on a stock exchange; (v) form and adequacy of disclosure; (vi) corporate governance issues; and (vii) relationships with independent service providers.

VI. Special Considerations for Creating and Managing a Fund of Funds Business

The final section of the Guide discusses additional issues that are unique to the manager of a fund of funds ("FOF"). Many of the sound practices for hedge fund managers mentioned in the first five sections of the Guide may also apply to FOF managers. However, the Guide discusses a number of issues that are unique to FOF managers, including: (i) due diligence on the underlying hedge fund managers; (ii) liquidity constraints; (iii) risk assessment at the underlying hedge fund manager level, the strategy level and the portfolio level; (iv) performance assessment of the underlying hedge funds; and (v) development and implementation of conflicts of interest policies.

The foregoing provides only an overview. Readers are cautioned against making any decisions based on this material alone. Rather, a qualified lawyer should be consulted.

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