

STRUCTURED PRODUCTS CLIENT ADVISORY

January 2007

CANADIAN SECURITIES ADMINISTRATORS ISSUE HEDGE FUND NOTICE

BACKGROUND

On January 12, 2007 the Canadian Securities Administrators (the “CSA”) published Staff Notice 81-316 – Hedge Funds (the “Notice”), which sets out the results of a review by the CSA of the hedge fund sector (including principal protected notes) and outlines some general concerns and courses of action which the CSA intend to pursue with respect to these products and the manner in which they are distributed. The issuance of the Notice by the CSA follows a period of compliance and disclosure reviews as well as general information gathering that took place between 2005 and 2006.

The general conclusion reached by the CSA following their review was that the existing regulatory regime in Canada is appropriate to deal with hedge funds but that certain areas within the regulatory framework could be improved. One of the most important pieces of information contained in the Notice was a confirmation that the CSA intend to introduce a registration requirement for fund managers (those who set up, operate and promote funds) as part of their Registration Reform Project, scheduled to be released for public comment shortly. Although the CSA recognize a general move to support increased retail access to hedge funds within Canada and around the world, the Notice does not refer to any specific new regulatory initiatives in this regard.

WHAT IS THE CSA CONCERNED ABOUT?

The following is a summary of the areas of concern with respect to hedge funds and principal protected notes (“PPNs”) which the CSA indicated warrant further monitoring and/or improvement:

Principal Protected Notes

On July 7, 2006 the CSA published Notice 46-303 - Principal Protected Notes (the “PPN Notice”) that outlined their concerns with respect to the distribution and sale of PPNs and indicated that further consultations would be conducted. The CSA reiterate the primary concerns which were originally set out in the PPN Notice, specifically: (i) PPNs may provide retail investors with access to alternative asset classes which carry different risks and are not usually available without a prospectus; (ii) insufficient disclosure being provided to investors concerning the PPN (e.g. information on the structure, fees and risks) to permit investors to make an informed investment decision; (iii) some PPNs providing exposure to complex investments which pose more investment risk than was contemplated when securities legislation was originally enacted to exclude or exempt financial institution deposits/guaranteed debt instruments from securities regulation; and (iv) certain registrants selling PPNs without meeting their know-your-client (“KYC”) and suitability obligations.

The CSA is continuing a period of additional industry and participant consultation with respect to PPNs and may introduce additional notices and/or regulatory initiatives specifically aimed at PPNs following completion of this period of consultation.

Referral Arrangements

The CSA remind registrants that, even in the absence of specific requirements under securities legislation or the rules of applicable self regulatory organizations (“SROs”), they are still bound by their obligations under securities legislation and their general obligation to act in the best interests of their clients when making referrals to hedge funds or related products.

The CSA have specific concerns about the roles and responsibilities of the different registrants involved in a referral arrangement, including who must disclose the existence of the referral arrangement to the client and the risk that registrants may refer clients to a seller of hedge funds or products linked to hedge funds based on the amount of the referral fee without considering whether such referral is in the best interests of their client.

The CSA intend to address their concerns relating to referral arrangements as part of the Registration Reform Project referred to above.

Distribution

The CSA want registered dealers and their salespeople to ensure that they have sufficient proficiency and knowledge of a hedge fund or hedge fund linked product in order to be a position to assess the suitability of these products for their clients. In addition, dealer SROs should monitor dealers and salespeople to determine if they are performing reasonable KYC and suitability assessments in connection with the distribution of hedge fund products.

Registration and Oversight of Fund Managers

The CSA will propose as part of their Registration Reform Project that fund managers (including managers of hedge funds) register with the applicable securities regulatory authority. While the CSA acknowledge that hedge fund managers or related entities may already be registered in the category of investment counsel and portfolio manager (ICPM) since they manage portfolio assets, it is felt that the role which fund managers play in the establishment, promotion and management of investment funds and the provision or oversight of a broad range of services to the fund (including valuation and registrar and transfer agency services) warrants an additional category of registration.

The registration requirements for the fund manager designation will likely focus on ensuring that managers: (i) have sufficient resources to perform their functions or to supervise the functions sub-contracted to third parties and to provide proper services to investors; (ii) manage any conflicts of interest; (iii) have adequate capital and insurance; and (iv) have sufficient proficiency and integrity to carry out their functions. Fund managers could also be subject to compliance field reviews by certain provincial securities regulatory authorities where the ability to perform these reviews exists.

Disclosure

In the CSA's view, disclosure (usually in an offering memorandum) for some non-prospectus offered hedge funds could be clearer. The CSA indicate that they intend to raise any disclosure concerns to hedge fund managers in the context of any compliance reviews which may be conducted. Generally speaking, other than in the context of the offering memorandum exemption provided for in certain Canadian jurisdictions, there is currently no prescribed form of offering memorandum in Canada for the sale of hedge funds on a private placement basis. However, investors in a hedge fund offered by way of offering memorandum are required to be provided with certain statutory rights of action for rescission or damages in the event that the offering memorandum contains a "misrepresentation" (generally defined as an untrue statement of a material fact or an omission to state a material fact that is required to be stated or that is necessary to make a statement not misleading in the light of the circumstances in which it was made).

With respect to prospectus qualified funds, the CSA will concentrate their efforts on issuers providing clear disclosure about a fund including structure, fees and risks associated with an investment in the product.

The CSA may also require the amendment or withdrawal of marketing materials in certain circumstances. Specific principles relating to the use of such materials include: (i) performance data should utilize standard periods and calculation methods; (ii) performance data for underlying funds or funds managed by the same adviser should make it clear that the disclosure relates to another fund under common management or if the fund being sold is linked to the fund being advertised; (iii) sales communications must include clear warning language relating to how data has been calculated and that past performance is not indicative of future performance; (iv) performance data must be sufficiently current so as not to be misleading; and (v) the materials must include clear and understandable disclosure of other key product elements (e.g. fees and costs).

Financial Disclosure and Valuation

In certain jurisdictions of Canada, privately offered hedge funds are required to prepare, file (or rely on an exemption from filing) and deliver financial statements in compliance with National Instrument 81-106 - Investment Fund Continuous Disclosure (“NI 81-106”). In the Notice, the CSA acknowledge some of the challenges certain hedge funds have faced in attempting to meet their obligations under NI 81-106 including: (i) completing the required financial disclosure for a fund within 90 days of such fund’s year-end where the fund is linked to, or invests in, funds located in jurisdictions which are not subject to NI 81-106; (ii) calculating net asset value (NAV) as frequently as typically required of other types of investment funds; and (iii) sensitivity to the disclosure of specific portfolio assets. In an encouraging sign for hedge funds, the CSA indicate that they will look at ways to balance the need for transparency required by NI 81-106 with a recognition of the unique financial disclosure issues relating to some hedge funds. This may mean that securities regulatory authorities will be more receptive to requests for exemptive relief from certain requirements of NI 81-106 in the appropriate circumstances.

With respect to the valuation of hedge funds, the CSA indicate that they will continue to examine issues such as: (i) the role of service providers in valuations; (ii) policies, procedures and internal controls in place at hedge funds relating to valuations; (iii) fund manager oversight of the valuation process; (iv) policies and procedures in place at Canadian based funds which invest in offshore hedge funds; and (v) work being done internationally with respect to valuations and financial disclosure.

WHAT’S ON THE REGULATORY HORIZON?

Based upon the areas identified in the Notice (and the earlier PPN Notice), the alternative investment industry can expect a push to have hedge fund managers (along with other fund managers) registered as part of the Registration Reform Project. Draft rules are expected to be published for public comment shortly and a final rule could be implemented as early as the first quarter of 2008. Once registered, hedge fund managers could be subject to compliance examinations and/or field audits. Valuation practices which are currently in place should also be reviewed to ensure that there are policies and procedures in place to calculate and verify fund valuations and to avoid potential conflicts of interest in the valuation process.

As part of the Registration Reform Project, registered dealers can expect specific rules relating to referral arrangements as well as an increased emphasis from securities regulatory authorities and SROs on ensuring that they and their salespeople have sufficient product knowledge relating to hedge funds and hedge fund linked products and are meeting their KYC and suitability obligations.

Participants in the PPN market can expect additional notices or potentially a specific rule relating to the offering and sale of this product following the CSA’s period of additional consultation, which is expected to be concluded within the next three months.

All participants in the alternative investment market can expect an increased level of scrutiny in relation to the offering documents (prospectus, offering memorandum or information statement) and any marketing materials used in connection with a distribution of these products. Issuers of these products should review their existing disclosure with a view to ensuring that they address any specific concerns identified by the CSA in the Notice.

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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