McMillan Binch Mendelsohn

Hedge Funds and Derivatives

Shahen Mirakian

Advanced Forum on Derivatives

May 1, 2007

The Canadian Institute

What is a hedge fund?

- No universally accepted definition
- For the purposes of this presentation:
  - Any private investment fund offered to investors by way of exemptions to the prospectus and dealer registration requirements in securities legislation
- Regulators use broader definition to capture all funds that use “alternative investment strategies” such as retail commodity pools

Hedge fund structures

- Domestic hedge funds
  - Limited partnerships
  - Trusts
  - Mutual fund corporations
- Offshore hedge funds
  - Exempted companies
  - Segregated portfolio / protected cell companies
  - Trusts

Why do hedge funds use derivatives?

- Speculation / investment
- Portfolio risk and cash flow management
- Hedging
- Structuring / exposure

Common transactions

- Currency derivatives to hedge risks associated with foreign holdings or to create foreign currency class of securities
- Cash-settled derivatives to gain exposure to offshore hedge funds without triggering tax under the proposed Foreign Investment Entity rules
- Forward transactions designed to allow offshore investors to gain exposure to Canadian investments without attracting withholding taxes

Common transactions

- Total return swaps to provide leverage to the fund as a whole or to create a leveraged class of securities
- Credit default swaps as an investment asset
- Commodity derivatives as an investment asset or for arbitrage purposes
- Equity puts and calls and combinations thereof for portfolio risk management purposes and for profit

Hedge fund market share

- Hedge funds constitute about 10% of all assets under management globally
- No clear numbers on hedge fund share in derivatives markets as a whole
- With respect to credit derivatives, hedge funds made up, by dollar amount, 30% of all protection buyers and 30% of all protection sellers in 2006 (BBA figures)

Hedge fund market share

- Contrary to the belief of many market participants, hedge funds likely make up fairly small share of derivatives market.
- Hedge funds have influence that outweighs their market share
- Hedge funds tend to be early adopters and make up a larger percentage of exotic derivatives
- Hedge funds tend to be more aggressive than other counterparties

Risks in dealing with hedge funds

- Unique risks associated with transacting with hedge funds
  - Structural risks
  - Lack of transparency
  - Regulatory risks

Structural risks

- Limited partnerships and trusts do not automatically have the capacity to enter into derivatives or give security over collateral
- Counterparties should examine limited partnership agreements or trust instruments (agreement or declaration) to determine if fund has capacity to enter into agreement
- Lack of capacity could result in agreement being unenforceable against the fund’s assets

Structural risks

- Limited partnerships must contract through the general partner (who may delegate such power to the fund manager or investment advisor)
- Trusts must contract through the trustee (who may delegate such power to the fund manager or investment advisor)
- Counterparties should add general partner / trustee as Specified Entities

Structural risks

- Counterparties should review limited partnership agreements or trust documents to determine if power can be delegated, as well as reviewing management and advisory agreements to determine to whom power has been delegated
- In some instances the power to enter into Master Agreement and individual transactions will rest with two different parties (e.g. general partner will enter into ISDA Master Agreement but investment advisor can authorize individual trades and execute confirmations)

Structural risks

- Counterparties should ask for a representation letter setting out that party which enters into agreement on behalf trust or limited partnership has power and authority to do so
- Counterparties should also request a legal opinion regarding capacity, power and authority from external counsel to hedge fund

Structural risks

- Additionally, counterparties should require delivery of any amendments to fund documentation to ensure that no new restrictions on capacity to contract have been introduced
- Counterparties should include an additional termination event based on any change in the fund manager or investment advisor (whichever they feel is more fundamental to the continued success of the hedge fund)

Structural risks

- Canadian business corporations have capacity of a natural person and therefore can enter into derivatives and give security over collateral absent restrictions in articles of incorporation
- Unlike most business corporations, hedge funds in corporate form will likely contract through their fund manager or investment advisor as agent for the corporation

Structural risks

- Offshore corporations do not necessarily have the capacity of a natural person
- Counterparties should ask for opinions from local counsel to hedge fund regarding capacity, power and authority to enter into derivatives and give security over collateral
  - Since derivatives agreement will likely be under Ontario law, this means that two separate opinions will be required (one from Ontario counsel regarding enforceability and one from offshore counsel)

Lack of transparency risks

- Unlike public companies or public mutual funds, hedge funds are not required to file financial statements
- In Ontario, hedge funds are required to comply with National Instrument 81-106
- In Alberta, British Columbia, Manitoba and Newfoundland hedge funds are not required to comply with NI 81-106

Lack of transparency risks

- NI 81-106 requires an investment fund to file:
  - Annual audited financial statements within 90 days of year end (including a statement of investment portfolio)
  - Interim unaudited financial reports within 60 days of period end (including a statement of investment portfolio)

Lack of transparency risks

- Mutual funds that are not reporting issuers (i.e. hedge funds) are not required to file these statements with regulators
- However, hedge funds must deliver these statements to holders of their securities
- Counterparties should require delivery of these statements (on the same schedule as NI 81-106) in the jurisdictions where they are available
- In other jurisdictions, counterparties should require disclosure similar to these statements (with at least annual auditing)

Lack of transparency risks

- Hedge funds also prepare statements of Net Asset Value per Unit according to their organizational and offering documents on a more regular basis
- Some hedge funds will publish these statements on their website or with a provider such as Globefund
- Counterparties should require regular delivery of these NAV statements
- Counterparties should also request more regular reporting of the hedge fund’s investment portfolio and the fund’s Net Asset Value

Lack of transparency risks

- Counterparties should request delivery of all notices to holders of the hedge fund's securities at the same time as such notices are delivered to holders
- Counterparties should monitor hedge fund NAV and NAV per Unit on a regular basis and include additional termination events based on significant, rapid declines in NAV and NAV per Unit

Lack of transparency risks

- Prior to entering into a derivative with a hedge fund, counterparties should familiarize themselves with the management of a hedge fund and satisfy themselves that the derivative is suitable for the hedge fund considering the sophistication of management and the objectives of the hedge fund
- Unlike the image of hedge funds in the media, many hedge fund managers are unfamiliar with at least some types of over-the-counter derivatives

Lack of transparency risks

- Counterparties should include representations making it clear to the hedge fund that they are not providing investment advice and that the hedge fund should not rely on the counterparty in making investment decisions regarding the derivative
- It may be prudent to go beyond the standard ISDA representations if a hedge fund is not familiar with the ISDA documentation

Regulatory risks

- Unlike public mutual funds, hedge funds are not subject to restrictions on use of derivatives in Sections 2.7, 2.8 and 2.9 of National Instrument 81-102
- However, where derivatives fall within definition of "security", counterparties must still comply with general rules governing trading in securities

Regulatory risks

- Hedge funds fall within part (n)(i) of the definition of “accredited investor” in National Instrument 45-106
  - *An investment fund that distributes or has distributed its securities only to a person that is or was an accredited investor at the time of distribution*

Regulatory risks

- Depending on their redemption schedule, Canadian hedge funds fall within part (k) or (l) of the definition of "Qualified Party" under Blanket Order 91-501 (BC)
  - *a mutual fund [or non-redeemable investment fund], if the investment portfolio of the fund is managed by a person that is registered under the Act or the securities legislation of another province or territory in Canada as a portfolio manager or equivalent;*

Regulatory risks

- Depending on their redemption schedule, Canadian hedge funds fall within part (R) or (S) of the definition of "Qualified Party" under Blanket Order 91-502 (Alberta)
  - *a mutual fund [or non-redeemable investment fund] if the investments of the fund are managed by a company that is registered under the Act or securities legislation of another province or territory in Canada as a portfolio manager;*

Regulatory risks

- Hedge funds with foreign advisors do not fall within the definition of “Qualified Party” under either Blanket Order unless all investors in such a hedge fund are “Qualified Parties” or they qualify as “sophisticated entities”

Regulatory risks

- It is not the duty of a counterparty to determine if a hedge fund is complying with securities laws
- However, in order to avoid future problems, a counterparty should determine that the investment advisor of a hedge fund is properly registered (
- This should be extended to the fund manager of a domestic hedge fund once proposed National Instrument 31-103 is in effect
- Counterparties should also include an additional termination event should the hedge fund violate any securities laws

Some tips for hedge funds

- Do not simply look for the best price; look for a counterparty that is comfortable with hedge funds
- It can be very expensive and time consuming to educate a counterparty about a hedge fund’s structure
- Experienced counterparties may not require local counsel opinions in familiar offshore jurisdictions
- There are benefits to using your prime broker for derivatives transactions (if they can provide them and the price is right)

Some tips for hedge funds

- Pay close attention to collateralization arrangements – daily margin calls may be operationally difficult for a smaller hedge fund
- There are minimum efficient scales for many derivatives based structures (e.g. at least CAD10MM to make a share basket forward profitable)
- Hedge funds should seek independent advice if they are not familiar with a derivative instrument

Some tips for hedge funds

- Documentation matters!
  - For hedge funds with a trust structure, include limitation of liability clause for professional trustees and unitholders (*Trust Beneficiaries' Liability Act* applies only to trusts which are reporting issuers)
  - Review Additional Termination Events to make sure they are not too onerous (e.g. a hedge fund with a volatile strategy should have a greater NAV decline before triggering an ATE)

Some tips for hedge funds

- Documentation matters!
  - Review Additional Termination Events to ensure they correspond to structure of hedge fund (removal of investment advisor should not be an ATE if periodic change in advisor is contemplated)
  - Review reporting requirements and deliveries to make sure they can be met (a hedge fund with monthly NAV statements will not be able to provide weekly NAVs)
  - Fund manager / investment advisor should not be a party to agreement in its personal capacity
  - Review assignment and transfer provisions and amend Section 7 of the ISDA Master Agreement if necessary.

Some tips for hedge funds

- Offshore segregated portfolio / protected cell companies
  - There is no official commentary or case law in Canada establishing that the assets of each cell will be isolated from other cells in the event of an insolvency, however it is very likely that a Canadian court will uphold the structure
  - For additional comfort, hedge funds should include language clarifying that a counterparty only has recourse to the cell's assets