

# HFMWEEK

SPECIAL REPORT

## CANADA 2011/12

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### REGULATION

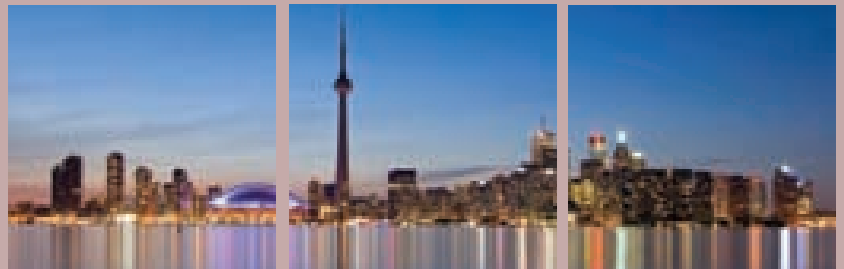
Canada's secure and solid regulatory environment ensures better protection

### OPPORTUNITIES

How Canada is rich in investment possibilities, in both fund structures and physical resources

### LAUNCHES

The best way to successfully start up a hedge fund in Canada



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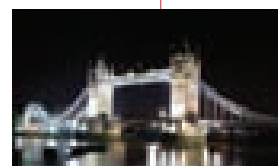
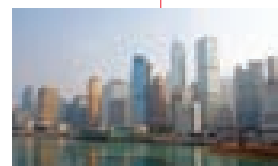
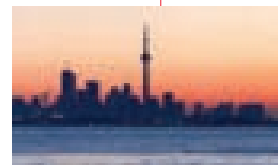
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he Canadian hedge fund industry has come a long way from its inception in the late 80s and early 90s. AUM continues to grow rapidly, reflecting the quality of managers (which has never been higher) the confidence of institutional investors, and the respect the Canadian

financial industry has earned in the international arena.

The establishment of the Canadian chapter of AIMA in 2003 was an important event for the industry in terms of bringing industry participants together to represent the Canadian industry with a common voice. As the voice of the Canadian hedge fund industry, AIMA Canada's mandate includes policy development, promoting sound practices, investor education and liaising with regulatory bodies.

What happened in Canada in 2008 for the most part was a microcosm of what took place globally – a number of funds in the Canadian market were hit hard, especially those that used leverage or had focused exclusively on long-biased equity strategies.

However, there were a number of strategies and managers that did very well and provided outstanding benefits to their investors in the most challenging of times. Although some of the weaker managers were lost during this period, the industry has emerged stronger than ever.

Today, Canadian hedge fund managers continue to perform well compared to equity markets and the majority of funds have exceeded pre-2008 high-water marks.

KCS Fund Management and Simon Fraser University in British Columbia, Canada published a paper in 2009 entitled *Risk and Return in the Canadian Hedge Fund Industry* (which won an AIMA Canada-Hillsdale Research Award) about the benefits of investing with Canadian hedge fund managers. The paper examined a broad range of strategies and compared Canadian performance with hedge funds located in other jurisdictions – concluding that Canadian hedge fund managers provide attractive opportunities to Canadian and non-Canadian investors.

From a regulatory perspective, Canada has had a comprehensive framework for money managers, including hedge funds, for decades. Some refinements and additional registrations have been implemented; however, while the additional regulatory burden continues to be a

challenge for new managers, it has not hampered growth in our business. On the positive side, there is a better understanding by Canadian regulators about hedge funds and their beneficial role within capital markets, which is a good thing for the industry.

In recent years, there has been significant progress in the institutionalisation of Canadian hedge fund managers. Better businesses are being built, focusing on operations, governance, risk management, separation of duties and transparency. As a result, a number of Canadian managers are ranked on a global basis as top quality managers, from both an infrastructure and a return/risk point of view.

Another positive sign for the industry is increasing allocations from institutional investors inside and outside Canada who are attracted to the performance and institutionalisation of Canadian fund managers and who wish to access Canadian funds, whether through Canadian based fund of funds or accessing Canadian managers directly.

There is no doubt that the shape of the Canadian industry has changed over the years, and will continue to change. High-calibre managers continue to enter the industry, typically from large financial institutions, creating additional choice and opportunity for Canadian and international investors. We have also seen the number of strategies being traded within Canada expand and some Canadian-based managers focused on international markets. This has resulted in a dramatic shift and growth in the AUM of the industry, which is estimated to have grown from \$12bn five years ago to more than \$30bn today. It is interesting to note a record number of Canadian based hedge funds have 'hard closed' over the past 12 months.

All of these factors bode very well for the future of the Canadian hedge fund industry.

*Founded in 1990, the Alternative Investment Management Association (AIMA) represents all practitioners in the alternative investment management industry globally – including hedge fund managers, fund of hedge funds managers, prime brokers, legal and accounting firms, investors and fund administrators. AIMA focuses on addressing issues affecting the industry's development and is involved in ongoing discussions at national and international levels about the future regulatory framework for the industry.*



**Gary K Ostoich**

JD, CAIA, is a hedge fund executive with more than 25 years' experience in the Canadian hedge fund industry. Currently, Mr. Ostoich is president of Spartan Fund Management, a Toronto based hedge fund, along with being chair of AIMA Canada.

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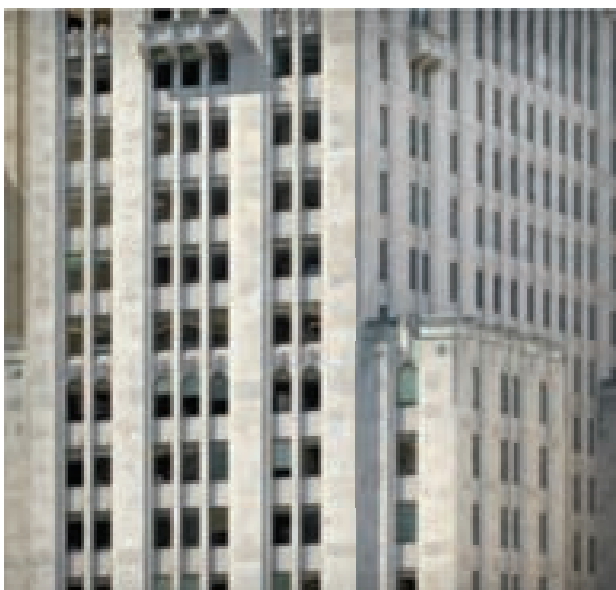
There is tremendous value in outsourcing the fund valuation and unit-holder recordkeeping functions of investment fund management, particularly when compared against performing these functions 'in-house'. Dennis MacPherson of SGGG Fund Services Inc explains how, with the right vendor, conversions can be completed quickly with minimal disruption

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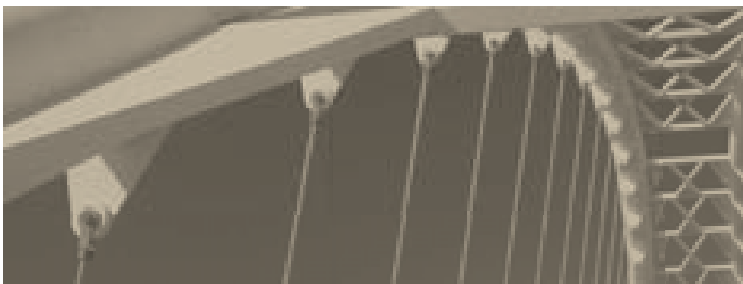
Eric Sprott and James Fox of Sprott Asset Management talk to *HFMWeek* about the true state of the economy, and how Canada can capitalise on its advantages



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# A WINNING STRUCTURE

AFTER THE RECENT FINANCIAL CRISIS, HEDGE FUNDS ARE UNDER MORE SCRUTINY THAN EVER BEFORE TO SHOW INVESTORS THEY HAVE A MODEL THAT IS SECURE AND RELIABLE. INDUSTRY EXPERTS **CHRIS PITTS** AND **MANJIT SINGH** EXPLAIN HOW CANADA'S INNOVATIVE TAX STRUCTURE ALLOWS CANADIAN HEDGE FUNDS TO BOAST A VERY HIGH LEVEL OF TRANSPARENCY



**Chris Pitts** is a partner in the asset management practice at PwC and specialises in the alternative fund sector. He is also a member of the executive committee of AIMA Canada.



**Manjit Singh** is an associate in the Toronto office of Wilson & Partners LLP. She maintains a general corporate tax practice that includes advising clients on the structuring and reorganisation of various types of investment vehicles, including offshore funds, real-estate investment funds and income trusts.

**W**ith the benefit of hindsight, the credit crisis is proving a defining moment in the evolution of the global, and Canadian, hedge fund sector. The resilience of the sector certainly won the interest of institutional investors seeking the potential for both protection in times of crisis and an attractive return profile over different economic cycles. "With this increased interest, however, comes a price of providing broader transparency into various aspects of a manager's operations, business and controls," says Chris Pitts, PwC's alternative funds lead partner in Toronto, "and due diligence sessions are getting more intense in these areas."

## OPERATIONS AND CONTROLS

The increase in investor appetite for hedge fund strategies has been well reported over the past year. Anecdotally we are also seeing a continued divergence between the larger and smaller managers, both in our onshore and offshore clients to whom we provide audit and other services from here in Toronto, with the lion's share of these inflows coming from institutional investors and being directed to the larger managers.

This can be attributed to investor concerns with transparency, both of portfolio as well as of controls and governance. As we reported in our recent PwC publication, *Infrastructure: from cost to benefit hedge funds 2.0*, these demands are raising the bar, and having the right people, repeatable processes and scalable technology has become more important than ever. Our experience is that the larger managers are enhancing their capabilities, driven by a combination of investor pressure and strategic positioning.

Investor due diligence is clearly becoming far tougher. It may involve not only an initial meeting to understand the control environment but also monitoring over many months and, in some cases, testing. In addition to seeing a robustly structured and managed control environment, institutional investors and their consultants are concerned about the fol-

lowing issues surrounding operations risks:

- Valuation policies and procedures, including detailed documentation;
- Existence, safekeeping and controls surrounding the fund's assets;
- Trading policies and procedures, including ethical guidelines;
- Compliance policies, supporting multiple regulatory demands.

Transparency into a manager's control environment gives investors comfort that a hedge fund manager has adequate checks and balances in place. Pension funds are accustomed to receiving controls reports from their traditional managers (for example; SSAE16, formerly SAS 70, and service organisation control reports) and they, along with other institutions and high-net-worth individuals, are now requesting them from hedge fund managers. These reports give investors the comfort of knowing that the manager's board of directors has concluded that it has appropriate controls in place, and that an independent auditor has tested the operational effectiveness of the relevant controls over a period of time to concur with management's view.

Such a report is still a competitive advantage in the hedge fund sector, but we expect it to become routine in future, as it is for administrators and will increasingly become for prime brokers. Globally we are starting to see managers with as little as \$1bn commission such reports – notably it is usually managers with high growth aspirations that do so.

Institutional investors are also increasingly looking for transparency into performance track records, and a growing number of requests for proposals ask for confirmation of compliance with Global Investment Performance Standards (GIPS) and provision of audited performance records. The standards themselves have recently been revised to enhance disclosures on fair value, risk and verification status, with changes effective from 2011. While GIPS has not been taken up by hedge fund managers to the same extent as traditional managers to date, we believe that investor pressure is likely

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MANAGER'S CONTROL  
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INVESTORS COMFORT THAT  
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AND BALANCES IN PLACE  
”

to increase. It is these strategic imperatives that are leading to the institutionalisation of processes, procedures and controls, with the cost of these demands driving a wedge between larger and smaller managers.

#### A CANADIAN PERSPECTIVE ON TAX EXPECTATIONS

The tax function is also an area where both capability requirements (to address a myriad of new and multi-jurisdictional rules and reporting) and systematic processes and controls are becoming more important – and our experience in Canada is certainly demonstrated by this. Requirements this year, for example, are expected to drive a renewed focus on tax compliance relating to eligibility for a treaty-reduced withholding tax rate on Canadian-source investment income.

“Over the past year, we have seen an increased level of diligence and review by global hedge funds of potential Canadian tax risks in circumstances where there is some involvement of a Canadian-based management team or where some operational activities are taking place in Canada” says Manjit Singh, an associate in Wilson & Partners, a law firm affiliated with PwC.

#### CARRYING ON BUSINESS IN CANADA

From an operational perspective, we continue to advise global hedge funds on accessing services from Canadian providers or raising capital from Canadian investors without risking carrying on business in Canada. The safe harbour rules addressing this tax risk were discussed in some detail in last year’s *HF-MWeek Canada Report* and generally operate well to support the use of Canadian service providers.

However since there are circumstances where the safe harbour rules may not be accessible, it is important to address potential tax concerns where a global hedge fund is proposing to operate outside the rules and is either expecting some of its operational activities to be carried on through a Canadian service provider or, alternatively, is intending to access pools of capital from Canadian investors. In light of the potential Canadian tax exposure to the fund and its investors, it continues to be prudent for a global hedge fund to seek advice in these circumstances.

#### CORPORATE RESIDENCY REVIEW

A corporate governance review of a global hedge fund structure may be warranted if entities within a structure have a board of directors that includes some Canadian-based directors. The tax concern is to ensure that such an entity does not have its “central management and control” located in Canada and thereby is not considered to be resident in Canada for tax purposes.

Determining the “central management and control” of a corporation extends further than reviewing where a majority of directors of the corporation resides. A detailed review is required of the process by which the effective decision-making relating to high-level matters of the corporation is actually carried on.

Our experience has demonstrated that often, over time and due to practical considerations, the actual decision-making practices of a board of directors may steer away from the intended corporate governance practices. As such, a global fund structure that includes Canadian-based directors may benefit from a periodic review of its corporate governance practices to ensure that the fund’s tax risk profile has not, inadvertently,

been altered over the years to create a tax liability or compliance obligations.

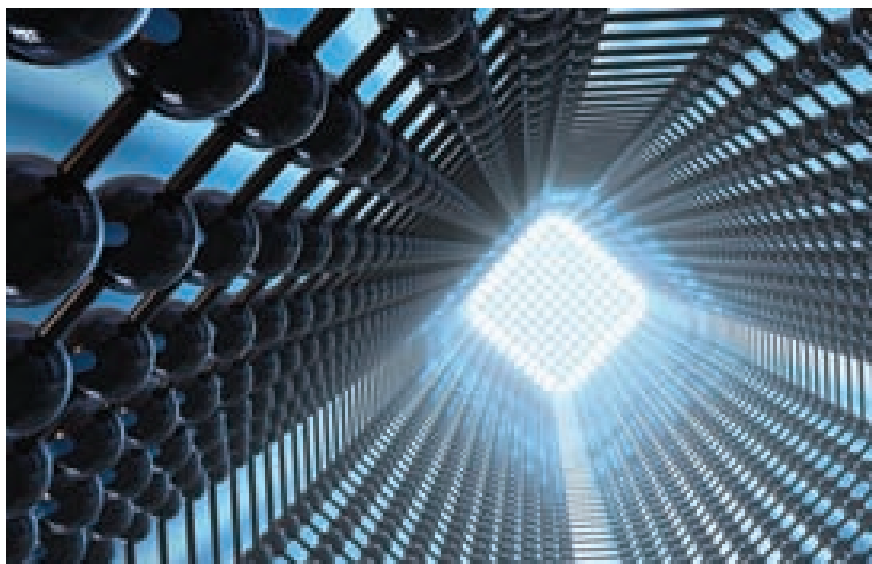
#### WITHHOLDING TAX COMPLIANCE FOR FUNDS INVESTING IN CANADA

In 2011 the Canadian tax authorities introduced new declaration forms for Canadian payment agents (such as prime brokers) of “income subject to withholding tax” to guide them on the level of due diligence and information they are expected to gather from non-residents to support the application of a treaty-reduced withholding tax rate. The forms represent a new tax administrative practice that is a change from previous practice.

Since these Canadian payment agents may be held liable for inadequate withholding tax (and related interest and penalties), we anticipate increased requirements for global hedge funds to provide these forms in order to demonstrate eligibility for the treaty-reduced rate, even though their use is not mandatory. Importantly, the legal structure of a global hedge fund determines the specific form and nature of information that may be requested, including potential for a look-through to ultimate beneficial owners for partnerships and hybrid structures to determine treaty eligibility.

Since Canadian payers have until 31 December 2011 to comply with these new administrative practices, funds may soon face requests for completed forms, and should consider seeking advice with respect to their compliance obligations. Organisational controls, whether addressing these requirements or those of other countries (such as the US’s new Fatca regime), are clearly playing a bigger role in hedge fund operations.

“A renewed focus on infrastructure and controls, and the right resources to build out the operations to a higher standard, is a distinct trend occurring at our clients both here in Canada and globally,” says Chris Pitts, “and drives across compliance, tax, financial reporting, legal and even marketing functions. Those that execute on this strategy gain an operational platform and complement of skills for the future that will satisfy greater investor and regulatory scrutiny.” ■



# THE RIGHT FIT

THE CANADIAN HEDGE FUND SECTOR CONTINUES TO GROW BUT REQUIRES MORE SOPHISTICATED SERVICE PROVISIONING TO KEEP UP WITH THE GROWING DEMANDS OF BOTH INVESTORS AND REGULATORS. **CHARBEL CHEAIB**, OF **CIBC MELLON**, TALKS TO *HFMWEEK* ABOUT THE INCREASING IMPORTANCE OF CHOOSING THE RIGHT SERVICE PROVIDER



**Charbel Cheaib**

is executive director of business development, and is responsible for leading CIBC Mellon's alternative investments business development efforts. Charbel began his career at a large accounting firm. He is a chartered accountant and based in Toronto.

**R**ecent market turmoil notwithstanding, the Canadian hedge fund sector has been experiencing rapid growth driven by healthy investment returns as well as new entrants to the market. Increasingly, sophisticated investors – whether they are pension plans, family offices or high-net-worth individuals – have looked to hedge funds as a vehicle to diversify their asset allocations and target elusive alpha returns. Accompanying this market growth has been the emergence of a number of asset servicing providers trumpeting their solutions and pedigree. Despite this rosy outlook, the industry is facing significant headwinds due to volatile asset valuations, global instability as well growing investor scrutiny.

Marina Lewin, managing director of alternative investment services at our parent company BNY Mellon, explored some key trends that are reshaping the industry in a recent knowledge leadership article:

**1. THE RISE OF HYBRID INVESTMENT STRUCTURES**

To attain alpha-level returns, major hedge funds are beginning to invest in illiquid assets like private equity funds creating hybrid investment structures. These new structures, featuring mixed investment strategies and asset classes, typically produce unique and complex regulatory, accounting and reporting challenges for hedge funds and their investors.

At the same time, hybrid structures are often beneficial serving as a creative investment vehicle that maximises investment returns, minimises risks and reduces costs for a given market. Service providers that can accommodate these operational and regulatory requirements will be in a better position to support the growth of hedge funds.

**2. DEMANDS FOR INCREASED TRANSPARENCY**

Recent financial crises have called into question the hedge fund industry's traditional opaque approach to portfolio and investment strategy transparency. During the 2008 crises, investors weren't able to fully identify their risk portfolios; when they did, it was often too late for some to limit their losses.

These days, investors need to understand where their investments are allocated and how they can maximise liquidity should the need arise. In this new environment, increased transparency for clients translates into improved reporting accuracy, more rigorous internal controls and better fund compliance.

Moreover, the growing role of institutional investors like pension funds necessitates hedge funds becoming more transparent. Consequently, they are being subjected to more extensive due diligence activities focused on their governance, investment decisions and operational procedures.

**3. GROWING REGULATIONS**

In response to the 2008 financial crisis, industry regulators from around the world passed a variety of far-reaching laws designed to protect investors, ensure capital markets liquidity and enhance transparency. For example, US lawmakers enacted the Dodd-Frank Bill in July 2010 which, among many things, stipulates special provisions for alternative investment funds. In November 2010, the European Commission passed the Alternative Investment Fund Managers Directive (AIFMD), a regulatory framework that includes new disclosure requirements and provisions on capital investment. Recently coming on stream in Europe is Ucits, a regulatory framework that features limits on the use of leverage, concentration provisions in individual securities and restrictions on direct

investments in commodities.

Whether you are an established hedge fund or a start up, choosing the right provider for your assets can be a challenge during transitional times like today. There has never been a more opportune time to gauge if your asset servicing partner is up to the task of efficiently and effectively delivering on your back-office needs and enabling business growth.

One way to evaluate a provider is through the core capabilities and pedigree they bring to the Canadian market. Given the mission critical nature of hedge fund operations, asset servicing providers need a unique combination of global scale, local knowledge and expertise and responsiveness to support their client's current and future needs.

“ THERE HAS NEVER BEEN A MORE OPPORTUNE TIME TO GAUGE IF YOUR ASSET SERVICING PARTNER IS UP TO THE TASK ”



## SCALE

Global scale brings a variety of advantages to Canadian hedge funds, including financial and operational stability, ability to attract talent and resources, and breadth of products that can cover the full gamut of a fund's needs. For perspective, CIBC Mellon services \$1.1trn in assets and more than 1,000 clients. One of our parents, BNY Mellon, is the global leader in asset servicing with more than \$26.3trn in assets under custody and administration.

CIBC Mellon delivers to Canadian hedge funds the international market access, globally deployed technology platforms and innovative product solutions of our parents. To enable our client's business, we can support domiciles in more than 100 markets through BNY Mellon.

Furthermore, scale confers important benefits on a product level. For example, we are witnessing an increase in the numbers of managed accounts. As liquidity and transparency have become more of a concern for both high-net-worth and institutional investors, managed accounts have become more popular and sought after. At the same time, this has increased operating costs. Having a reputable service provider is often enough for an institutional investor to accept a pooled product rather than requiring a segregated or managed account. Finally, if your firm is a start up and the operations team is also the investment management team then our level of expertise will be a key differentiator.

## LOCAL KNOWLEDGE AND EXPERTISE

Every market is different for a host of reasons, and Canada is no exception. For example, the Canadian market is experiencing an increase in the number of fund acquisitions and mergers within similar fund families as well as two fund families coming together. Investor needs, regulatory issues and market dynamics puts a premium on hedge fund service providers who have a deep bench of local knowledge not to mention a sizable local infrastructure that features client support, product and operations, risk management and relationship management.

Having a local depth of expertise combined with the global breadth of our parents is also a major service differentiator. International and local regulatory frameworks are but one area where robust asset service providers are standing out by offering operational solutions that have been proven with other international clients. In addition to helping our clients deal with operational issues surrounding HST, we are now collaborating with them regarding Fatca (Foreign Account Tax Compliance Act) to ensure their systems and process are able to meet the requirements and helping them fill in any gaps.

## RESPONSIVENESS

Delivering hedge fund servicing products are merely the beginning of a long-term business partnership. CIBC Mellon believes in proactively delivering value add products and services, whether it be globally proven, industry-leading expertise from CIBC and BNY Mellon for large pension plans or start up assistance for new hedge funds. Our customised solutions allow hedge funds the ability to mix and match products and solutions, providing the optimal back-office custody, accounting and analytics solution that meets your needs.

Another way a hedge fund provider can add value is by helping your business navigate through the significant regulatory changes on the way (e.g. Fatca, Dodd-Frank, AIFMD), many of which have important operational implications. A responsive service provider will be proactive around any foreseeable changes that will impact your business and has the expertise and team to ensure effective reporting, compliance and operational performance.

Not all hedge fund providers are equal. It is worth fund managers taking time to carefully review the various options in the Canadian market against their need for local knowledge and expertise, global scale and platforms as well as client focus. We are confident that when comparing hedge funds providers, CIBC Mellon will clearly emerge as the preferred choice for discriminating managers looking for proven operational performance, client service excellence and value. ■



# RBC Capital Markets



## PRIME BROKERAGE EXPERTISE.

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# THE PATH TO SUCCESS

HFMWEEK TALKS TO BMO CAPITAL MARKETS ABOUT THE BEST WAYS FOR START-UP MANAGERS TO ESTABLISH NEW HEDGE FUNDS, AND HOW HIGH-QUALITY PRIME BROKERAGE CAN FACILITATE THIS



**BMO Capital Markets**  
is a leading, full-service North American financial services provider with nearly 2,200 employees operating in 27 locations around the world. BMO Capital Markets is a member of BMO Financial Group, which has \$499bn total assets and more than 47,000 employees.

**T**he hedge fund industry has become an extremely well developed, if slightly complex, business in recent years. With assets under management growing into the billions for even the smallest funds, entering such a global, intricate market these days is a serious endeavour. Not only are there copious amounts of regulation to contend with, but also getting heard on such a busy market can be near impossible. BMO Capital Markets explains the best ways for start-up managers to hit the ground running and get on the path to success as quickly as possible.

**HFMWeek (HFM): What do investors look for when allocating to start-up managers?**

**BMO Capital Markets (BMO):** Raising assets is one of the main challenges new funds face. Competition for investor allocations is intense. Even with very particular investment parameters, investors have a multitude of funds to choose from so managers need to examine every aspect of their business and how it is structured. In the current environment, funds need more than a solid strategy and positive returns to attract capital.

**HFM: Why do investors care about how a hedge fund is set up, if the returns are good?**

**BMO:** BMO Capital Markets Prime Brokerage speaks to many start-up funds that have perfected their investment strategy but have not given as much thought to the other aspects of their business. Aside from the quality of the investment strategy and how it is executed, investors are particularly concerned with the operational structure and processes within the funds that they allocate to. Recent well publicised hedge fund failures such as Bernie Madoff or Amaranth Advisors have increased investor scrutiny, and have led to more upfront due diligence to be focused on operation aspects.

Executing proper operational due diligence includes examining items such as the fund's legal structure, the liquidity mechanisms (lock-ups or gates), business continuity and disaster recovery planning, fraud risk, corporate governance, operational process review and compliance and regulatory risk.

Investors expect managers to adhere to best practices by having a dedicated operations person or team in place. Choosing the right service providers enables a fund to streamline its own operations department and reduce

administrative expenses. It is essential to choose service providers carefully and work only with the highest quality organisations.

**HFM: How can choice of service providers assist with raising capital?**

**BMO:** A fund's choice of legal counsel, fund administrator and prime broker impacts every aspect of a fund's business and has a significant impact on the ability to raise capital. Service providers must be reputable and have a solid understanding of the strategy, legal structure and operational set-up of their hedge fund clients. Above all, the service providers that a fund selects must be completely independent to avoid all conflicts of interest and the appearance thereof.

The legal counsel will work with the manager to decide the appropriate legal structure, whether the fund should be domiciled onshore or offshore, and will guide the manager through the process of registering with the applicable securities regulators. Making the wrong upfront decisions with respect to fund structure may impact the type of prospective investor the fund may want to target at a later stage. Changing structure at a later date may prove costly to the fund.

The fund administrator works with the manager on a daily basis and is familiar with all aspects of the fund's business. The main functions of an administrator include fund valuation and client reporting. The administrator will work with the manager on trade reconciliation and maintain a securities master to strike the monthly net asset value (NAV). The administrator works closely with the accounting firm that executes the fund's annual audit and with the prime broker who holds the funds positions.

The traditional role of the prime broker encompasses all aspects of operations including clearing and settling trades, providing custody for the fund's holdings, processing corporate actions as well as securities lending, margin finance and consolidated reporting.

Many prime brokers also offer capital introduction services to their clients. The programme's goal is to introduce funds to potential investors and assist them in their marketing efforts. The BMO Capital Markets capital introduction programme includes several initiatives to benefit hedge fund clients:

- A quarterly alternative investment catalogue that is

distributed to more than 700 investors internationally

- Arranging one-on-one meetings that introduce hedge funds to targeted investors based on the investor's allocation parameters
- Organising and hosting capital introduction events where investors are invited to learn about alternative investments and listen to BMO's hedge fund clients discuss their strategies
- Assistance with marketing presentations and presentation seminars
- Intelligence about capital raising trends

While the benefits of a capital introduction programme are immediately obvious to all start-up hedge funds, there are many other ways that having the right prime broker can make a fund more attractive to investors.

**HFM: How can the prime broker's middle and back office support a new fund?**

**BMO:** Choosing a prime broker is one of a manager's most important decisions, and careful strategic considerations are necessary. The prime broker must be able to support the fund as a start-up and accommodate its changing needs at all stages as it grows to the optimal size.

All managers should be sure that their prime broker has the operational robustness to accommodate a fund's strategy. The majority of hedge fund failures are due to operational mishaps rather than being performance related. Investors won't allocate unless they are comfortable with operational structures of the fund and the service providers.

The importance of choosing a prime broker with a solid operations department cannot be overstated. BMO Capital Markets prime brokerage has a client service group that acts as a liaison between the hedge fund clients and BMO's back office. The prime brokerage associates review the fund's activity every day to ensure that the daily transactions are processed, to verify that all trades have settled and check that all corporate actions, entitlements and dividends have been posted properly.

Prime brokers offer a vast suite of reports providing extensive information about the client account. Factors

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include the types of reports and customisation, the ability to interface with multiple applications, the format and availability of data, as well as being user-friendly. BMO's reports are offered in a variety of formats including PDF, Excel, CSV, online interfaces and via FTP servers. This flexibility allows the funds and other service providers easy access to the necessary reports in the most convenient format.

A good prime broker will provide some level of risk reporting and analytics for each fund that it has a relationship with.

BMO Capital Markets has a relationship with RiskMetrics that provides funds with scenario analysis and portfolio stress-testing, which includes an analysis of what the portfolio would look like if subjected to several recent financial events.

A fund should consider the quality of the securities lending desk before establishing a prime brokerage relationship. Factors to consider are the ability to acquire difficult-to-borrow securities and the amount of protection the prime broker can offer against recalls and buy-ins. BMO's clients appreciate the level of protection from recalls and buy-ins. This level of service is extremely valuable to the fund as it allows the manager to maintain money-making positions that contribute to fund returns.

**HFM: Finally, does a prime brokerage relationship provide access to the rest of the firm?**

**BMO:** A prime brokerage relationship with BMO is an introduction to all areas of the organisation including derivative products, trading, foreign exchange and research. An integrated relationship will ultimately provide better service to the fund – both because the fund is a known entity at the firm and because the fund is a more meaningful client to the prime broker.

A fund's ability to raise capital extends far beyond the investment strategy and the returns. Allocators won't invest in a fund unless they feel their interests are protected and they have confidence in how the manager runs the business. Careful selection of service providers will be helpful when raising capital and will allow the manager to focus on their core skill – generating returns. ■





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# GOING GLOBAL

PATRICK BLESSING AND KRIPA KAPADIA OF SCOTIA CAPITAL TALK TO THE *HFMWEEK* CANADA REPORT ABOUT THEIR INTERNATIONAL EXPANSION, TAKING THE LESSONS THEY HAVE LEARNT IN THE CANADIAN MARKET AND BUILDING ON THEM ON A GLOBAL SCALE



**Patrick Blessing**

is a managing director and co-head of Scotia Capital's Global Prime Services Business. Patrick joined Scotia in 2004 and has been an integral part of the management team that has expanded the Prime Services business globally.



**Kripa Kapadia**

is responsible for sales and marketing in Canada for Scotia Capital Prime Services, and is also a senior member of the global capital introduction team, joining Scotia Capital prime brokerage in 2005.

**W**ith the hedge fund industry experiencing rapid growth and globalisation, more and more operators within Canada are expanding their presence internationally and spreading Canadian hedge funds' appeal to a world-wide market. Having to adapt to different markets, investors and regulations can be a challenging task but Patrick Blessing and Kripa Kapadia explain how a well-planned campaign of playing to existing strengths and taking into account new regulatory environments will allow them to navigate the business accordingly.

**HFMWeek (HFM): How is Scotia Capital expanding its international presence?**

**Patrick Blessing (PB):** Since the credit crisis in 2008/2009, we seized upon the opportunity that was presented to our prime services business to expand our presence globally. Prior to the crisis, we were able to lay the foundation through the opening of prime offices in Toronto, New York, London and Singapore. However, post crisis, the opportunity that was presented really enabled us to resource the business more effectively.

The first thing was the quality of the talent attracted to join a Canadian headquartered bank with global prime services capabilities. Along these lines, during the past year, we have hired a team in New York, starting with my partner John Stracquadanio. John led the team to be the first Canadian bank to offer full service US domestic prime brokerage services, which I feel is quite a compelling niche these days.

Following on from that, the opportunities to work with global hedge funds as a Canadian bank are very strong. I think a lot of our hedge funds clients found that just diversifying within the same banking jurisdiction does present itself with some systemic risk. What we talk about regularly with our hedge fund clients is the importance for jurisdictional diversification, which has become quite a powerful message.

We have also now expanded the team in Europe and Asia, for similar reasons as our US expansion, namely, the appetite to diversify to a Canadian headquartered bank with local market presence and expertise has never been stronger.

**HFM: In such a busy international market, how does Scotia Capital stand out from the competition?**

**PB:** Obviously prime brokerage is a very competitive business, and I think it is important to demonstrate a niche that clients will respond to. Our niche revolves around our strengths (AA- rated credit quality, strong balance sheet and local market expertise). Thus, when we talk to prospective customers, we stand out in how we tackle issues facing hedge funds today, like counterparty strength and asset protection.

Obviously in a post-Lehman world, hedge funds are very sensitive about the counterparty that is custodian of their assets, and I think that really plays to our strengths. We can offer funds the strength and stability of Scotia, combined with strong local product expertise. That is really the key message.

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OPPORTUNITIES TO WORK  
WITH GLOBAL HEDGE  
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**HFM: Which domiciles do you see as being the most viable currently?**

**PB:** Obviously with increasing regulation, investors are much more sensitive to where that fund is domiciled. Historically, in Europe for example, some of the most popular fund domiciles have been Ireland and Luxembourg. Those domiciles remain very important. I think an interesting domicile that has been showing

some growth in the offshore community has been Malta, which has developed some decent expertise and has been accepted by a number of the offshore investors. From a North American point of view, Cayman Islands remain the domicile of choice with increasing competition from various Caribbean domiciles aiming to get a larger slice of the offshore fund community.

**HFM: How is domiciling a fund in Canada different to other domiciles? What certain considerations need to be taken, and has this had an effect on Scotia Capital's decision to expand its global presence?**

**PB:** Domiciling a fund in Canada does have its differences compared to the rest of the world. First of all, Canada has a series of different provincial regulators rather than one national regulator in terms of the hedge fund industry. Anyone managing external client money for a hedge fund has to be registered with the local provincial regulator. Historically, there has been a strong regulatory culture

here in Canada. There are also a significant number of high quality local service providers. From administrators and lawyers to auditors and, of course, prime brokers. This strong local infrastructure has started to service a growing international client base.

**Kripa Kapadia (KK):** In terms of our global presence, we have been seeing tremendous interest from US and European managers setting up Canadian structures to tap into the Canadian investor base. Generally, with Canadian domiciled funds, investors tend to be high net worth/retail based. This typically requires expertise from local fund administrators to manage the intricacies. From our standpoint, our international capabilities only assist in our ability to service non-Canadian funds establishing a Canadian structure, as well as servicing our Canadian managers with their US domestic and offshore structures when marketing to investors in those regions.

**HFM: What funds do you see currently as the most popular with investors?**

**KK:** Certainly this year we have seen a lot of interest from the high-net-worth and family office community in looking at more liquid, equity-focused strategies: long/short, market neutral and, generally, lower directional equity strategies. Given the recent market volatility, global macro, CTA and other types of short-term trading funds are increasingly of interest as well. We have also seen significant interest locally for funds

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that produce a decent yield. Hence fixed income, and particularly credit related strategies, have been receiving significant interest.

**PB:** I think what we have seen overall is really that investors are getting back to the traditional, more liquid, hedge fund strategies. To add to Kripa's point, I think the idea is that during the crisis the investors got caught out in a number of situations where liquidity became a major issue.

**KK:** In terms of non-Canadian investors, we have seen an increasing appetite for Canadian-focused managers – i.e. hedge funds that have a bias towards investing in Canadian assets. I believe the ongoing strength of global commodity markets, in addition to the resilience of the Canadian banking sector, has increased appetite for Canadian exposure with investors who never considered Canada before.

**PB:** Canadian hedge funds have a lot of potential due to certain dynamics at work – one being the size of the hedge fund industry in single manager funds, which we estimate at approximately C\$25bn in assets. It sounds like a large number but it represents around 1.5% of the globe's hedge fund assets. That's also smaller than Canada's representation in global equity indices. However, this is also the opportunity. When you have fewer hedge fund assets chasing similar opportunities, there are more inefficiencies prevalent in the Canadian market relative to other developed markets. That really provides some of these managers opportunities to generate Alpha. We have seen more activity from international hedge funds investing in Canada, but I firmly believe that the investing market is still dominated by Canadian hedge funds.

**HFM: What can you see the next 12 months holding for Scotia Capital? Are there any possible obstacles you think you will have to consider?**

**PB:** We are going to continue our expansion of the US prime brokerage business and continue to enhance our global prime brokerage platform that will benefit our entire client base. It is a very exciting time for us as we have taken a step forward to resource the business globally. For hedge fund clients, jurisdictional diversification will remain a very compelling reason for hedge funds to select their financing counterparties. We deliver a strong product to accommodate that.

Obstacle-wise, I think we are in the same situation as any global bank in the fact that there is great uncertainty out there due to the shifting regulatory landscape and how we have to resource the business to accommodate that. A significant amount of time has been spent on assessing the legal and regulatory environment and the upcoming changes, particularly in Europe and the US, that are going to impact banks, prime brokers and the hedge fund industry. I think it is just a case of making sure that we are putting resources towards reviewing and assessing the impact of these changes and navigating the business accordingly. ■



# RIGHT PLACE, RIGHT TIME, RIGHT PLAN

GURMEET AHLUWALIA AND MICHAEL SLEIGHTHOLME OF CITI FUND SERVICES SHARE THEIR THOUGHTS ON HOW THE CANADIAN FUND MARKET'S STRENGTHS SERVE THEIR SERVICING MODEL, ESPECIALLY IN LIGHT OF THE CURRENT APPETITES OF INVESTORS



**Gurmeet Ahluwalia**

is head of Citi's Securities and Fund Services business in Canada. He is responsible for the development and profitability of Citi's SFS products, which include Custody, Securities Finance, Alternative Investment Services, Fund Services and Agency & Trust Services.



**Michael Sleightholme**

is the managing director of Citi's Hedge Fund Services. As global head of Hedge Fund Services, Mike is responsible for innovation, for driving and implementing the business strategy, the P&L of the business, and for managing risk across the business.

**T**he recent growth of the hedge fund industry has been paralleled by a change in investor trends. As the gap between traditional investment portfolios and new, regulated funds begins to widen, more work needs to be done to make sure business runs smoothly and that there are still healthy inflows for both kinds of funds. Gurmeet Ahluwalia and Michael Sleightholme explain how their concentrated efforts in customising investment solutions for each individual situation, allows them to stand out in such a competitive and crowded market.

**HFMWeek (HFM): How does Citi keep ahead in such a competitive market?**

**Michael Sleightholme (MS):** The short answer is through continued IT investment. If you look at the alternative investment (AI) business, how it has involved from both a management and an investment perspective, it has become a far more complex business than it used to be. Investors are demanding a lot more from managers in terms of transparency, better liquidity terms and other similar elements. Regulators are going to be asking for a lot more. Even as regulation is still being formulated, some quite onerous requirements are coming up, such as Form PF and potential clearing of derivatives, which is being talked about extensively.

It all means, as an alternative investment manager, that it is a more complex business, making it harder to attract new assets than it was before, as well as making it harder and more expensive to retain such assets. From a service provider perspective, it is good news – it provides opportunity to help managers to position themselves for growth. How we have done it is through continued IT development. We can offer solutions that allow managers to scale their operations a lot more effectively whichever way they are looking to grow. We see a lot of alternative managers launching more registered type products, which poses challenges to traditional AI type managers who are not really geared up for that sort of thing. So, developing IT to provide solutions that are going to help managers right across the investment value chain in whatever types of assets they are trading, whichever kind of geography they are trading in and whatever type of fund wrapper they decide

to put around their investment portfolio; that is really what we are geared up to do.

**HFM: Why did Citi choose Canada to be the centre for AI services?**

**Gurmeet Ahluwalia (GA):** We are a centre for AI services, not the only one in terms of North America, but Canada is becoming a larger component of it. About a year and a half ago, Citi did a full evaluation of our global transaction services business looking at our business around the world and determined that Canada was very much a core country for us in terms of having an opportunity for growth and having a strong franchise already. We had a large footprint in Canada, especially in the funds business

mostly with registered products in the Canadian market place. We already had the technical and operational expertise, as well the service model and service culture, which we figured would be very beneficial to our AI clients as we were looking for a location outside the Caribbean. There, the opportunity to grow is essentially limited either by rule of state or HR availability. The Toronto area became a very natural option for us because we had a large footprint from a safe contingency.

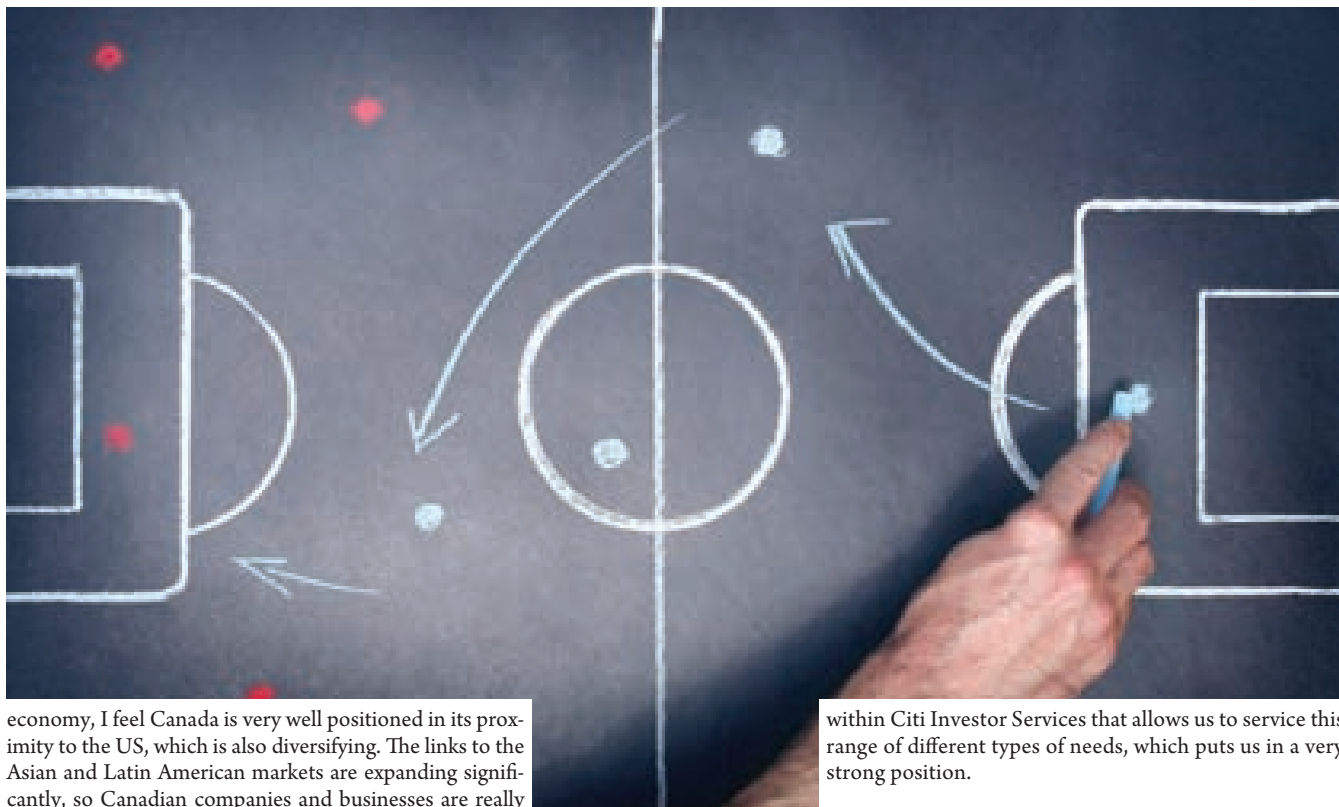
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standpoint, we have a number of experienced employees working within the funds space and performing effective services that clients required. Our clients were very happy with us taking the service culture we had already established and applying it to our hedge fund services.

**MS:** Toronto does indeed have a very strong talent pool generally, and given Citi's existing footprint there, Toronto is a very obvious location for us and it has worked extremely well. We consider it to be a centre of excellence, we have grown it quite substantially over the last 12-24 months from an AI perspective, and it is going very well from a client service perspective, which is the ultimate measure, so it has been a very positive move.

**HFM: What advantages does Canada have as fund market?**

**GA:** As a market in general, Canada is a very open and transparent market with a strong regulatory regime, with cooperation between the different industry players. As an



economy, I feel Canada is very well positioned in its proximity to the US, which is also diversifying. The links to the Asian and Latin American markets are expanding significantly, so Canadian companies and businesses are really striving to enhance those ties. Our strong resource-based economy helped in that way and these international ties have been very beneficial. Moving specifically to the funds market, I think Canada has some strong competition out there and it is almost a combination of niche, specific players with larger, more 'supermarket' funds that are increasing in size.

**HFM: What is the future for AI and non-AI services in Canada?**

**GA:** What we are seeing with our AI clients in the marketplace is that there is some potential convergence happening, where AI funds are looking to get broader distribution and more 'retailisation' while joining some of the other markets, where they know that to build an investor base they might need to open their doors and become more like a retail product. Regulators are looking at AI funds more closely and potentially bringing in regulation that will place extra scrutiny on them. From a non-AI perspective, we are seeing funds searching for alpha and that sometimes means looking at more hedge-like or AI-like products. From a service provider standpoint, what that means for us is that we can leverage our large footprints around the world in both the AI and non-AI sides and bring that experience to our clients.

**MS:** This echoes what we are seeing globally in many markets, as that convergence theme is definitely happening. We see a lot of AI managers looking to register products around the globe to help them become more retail-like and broaden their distribution base. On the other hand, we do talk to mutual fund managers who have alternative products. So, we have a toolbox

within Citi Investor Services that allows us to service this range of different types of needs, which puts us in a very strong position.

**HFM: What challenges are there currently in the Canadian market?**

**GA:** One is the view that there will be cost pressure on registered fund managers as investors begin to look at expenses and charges, and want to bring them down. Especially as competitive products come into the marketplace, whether it is alternative or other registered products, so the competition for the registered dollar is potentially becoming more cost-focused. At the same time, it is looking for the ever elusive extra dollar of alpha. Without the tools to see the transparency, the actual costs of the risks taken on by entering new markets can put the business at risk.

**MS:** Many key markets managers are facing the same issues and concerns, so for service providers it is generally a good thing that managers are looking for strategic partners to help them. It is also challenging because it means you've got to communicate with investors right through the process.

**HFM: What factors were taken into consideration when developing the Citi servicing model?**

**GA:** It starts with the clients, ascertaining what the best model is that can be used to satisfy clients. I would say innovation then follows – 'how do we leverage our global footprint with the ability to contain costs and thereby pass savings onto clients?'

**MS:** Operating this business consistently across different geographies and covering all asset classes that people want to trade, and supporting all fund wrappers and legal structures are the most important dimensions to take into consideration. We start with clients to see how best we can tailor the solution to them. ■



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# HOW CANADA CONTINUES TO BE A SOUND AND STABLE MARKET

AS THE GLOBAL FUND MARKET LOOKS TO REPAIR ITS WOUNDS SINCE THE RECENT FINANCIAL CRISES, *HFMWEEK* LOOKS AT HOW CANADA HAS RECOVERED. **ANDREW THORNHILL** OF **RBC CAPITAL MARKETS** EXPLAINS HOW THE MARKET IS STRENGTHENING, SPECIFICALLY THROUGH PRIME BROKERAGE.



**Andrew Thornhill** is a managing director at RBC Capital Markets with more than 20 years of experience in the investment industry, almost all in equity finance and prime brokerage. He has managed the equity finance desk in Toronto since 2002 and prime brokerage since 2009.

**B**y now, everyone has heard a news report or read an article praising Canada's resilience during the global financial crisis. It was a watershed moment for Canada, and especially for its financial industry. We have come of age.

So, why did Canada fare so well? There was a time when Canada may have been accused of not taking enough risks, not being financially creative enough, and perhaps being overly regulated. The basis of the current strength and stability of the Canadian financial system can be traced back to two historic events that occurred almost two decades ago – the removal of restrictions on the four 'pillars', and the government's focus on reducing the Canadian debt and eliminating deficits.

The Canadian financial landscape is made up primarily of institutions operating across all of the traditional four pillars – banking, securities dealers, insurance and trusts. Unlike the US where there are thousands of banks under various regulatory frameworks, in Canada there are eight chartered banks, five of which have operations beyond Canada's borders. Given that the chartered banks are federally regulated, it provides, to a certain degree, a centralisation of the political, supervisory and regulatory authority.

Canada's strong regulatory framework reflects cohesive and sound monitoring by regulators such as the Office of the Superintendent of Financial Institutions (OSFI) for banks, provincial securities regulators (such as the OSC, BCSC, etc.) for capital markets, and the Investment Industry Regulatory Organisation of Canada (IIROC) for securities dealers.

The OSFI has substantial discretion to provide guidance and takes a principle-based approach to regulation. Banks manage their various lines of business and are required to prove compliance, which fosters a best practices business culture. Policies are focused on risk-based prudential regulation, including more stringent capital requirements and higher leverage caps than the global average. Canada's

banks are among the best capitalised in the world and did not require the support of public funds during the crisis. In fact, Canada's banks were able to easily raise Tier 1 capital through private markets.

Provincial securities regulators focus on a balanced approach to protect investors and foster fair and efficient capital markets. The regulatory system allows market participants to access all Canadian jurisdictions by dealing primarily with its principal regulator. The cooperation between provincial jurisdictions offers harmonised treatment for participants.

IIROC regulatory requirements are generally based on worst case scenarios and do not rely solely on market risk tests. To some, the capital requirements for firms and clients may seem excessive and even punitive. However, these requirements enabled firms to withstand the market volatility of the global financial crisis, as well as the most recent shocks in the markets, taking into consideration that liquidity risk reduced the odds of a 'death spiral' effect where capital requirements are tightened

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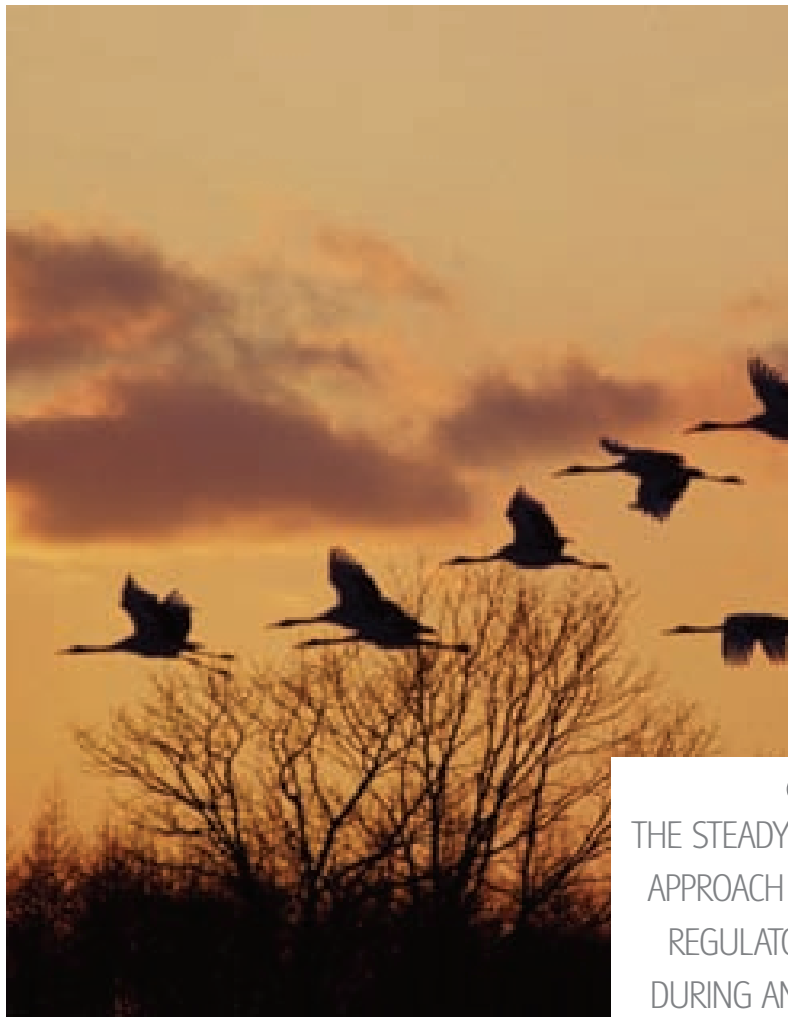
in a volatile and falling market.

Having a strong and consistent regulatory regime allows banks, trading desks and investment managers to make prudent and calculated investment decisions without having the rules of the game changed part way through the event.

Good regulation isn't the whole story. Canadian financial institutions weren't subject to the same stresses as other countries. Banks were well capitalised and leverage was well managed. The Canadian housing market was stronger and more stable, and it was not subject to the sub-prime fallout that occurred in other nations as Canadian lenders are generally more conservative and apply prudent mortgage rules to their lending businesses.

All of these factors placed Canada in a better position before the crisis to withstand the market turmoil and enabled the country to fare better than most.

That said, Canada isn't resting on its laurels. As much as the global financial crisis highlighted everything



that Canada did right, it also revealed what went wrong in other countries, and Canada was not immune to the effects. Canada's regulators are actively taking part in global initiatives to strengthen the global financial system, including incorporating Basel III proposals in capital adequacy and liquidity guidelines for banks. Indeed, Canadian banks have already begun to implement some of the new guidelines ahead of requirements.

Provincial securities regulators, jointly with the IIROC, have taken steps to further increase capital markets transparency with initiatives such as enhancing oversight of securitised products, improving regulatory oversight of OTC derivatives transactions, and implementing a new regulatory framework for the use of dark liquidity. These initiatives support innovations in the Canadian market while ensuring strong regulations are in place to protect the integrity of Canada's capital markets.

Canadian regulatory bodies often collaborate to

achieve similar objectives and reduce the potential for regulatory arbitrage.

Why is this important to understand? Post crisis, there were two forces that transformed the prime brokerage landscape. Hedge fund managers began to take a serious look at custodial and counterparty risk. At the same time, prime brokers began to tighten margin rates, and many of the large prime brokers established higher minimum hurdles for client requirements. These forces led to significant changes in the industry, including the proliferation of the 'mini' or 'introducing' prime brokerage business in the US.

In the midst of the market turmoil, Canadian prime brokers also reviewed their counterparty risk and ended relationships with smaller and more risky clients, but not to the same extent as what may have occurred in other markets. Three years later, the transformation continues. Mini-primes are now consolidating, the large primes are speaking to a broader client base again, and hedge fund managers are realising that operating under multi-prime scenarios can introduce operational inefficiencies that often translate into higher costs.

Canadian prime brokers are also looking at their clients differently. They are looking for long-term business relationships with their clients and are conducting due diligence reviews beyond the traditional cursory look at the latest financial report. Some may view the new risk

management and enhanced know-your-client reviews as intrusive, but others will take comfort that their prime broker and business partner is asking the right questions, and continuing to support Canada's strong and stable capital markets.

Throughout all this transformational change, Canadian prime brokers (all of which are bank-owned) remained sound and true to their offering with expertise in funding and securities lending, as well as world-class operations. They indeed benefitted from the flight to diversify counterparty risk. The funds that diversified their custody risk by adding a Canadian prime broker found that the core services were comparable, if not better, than what was offered at the large bulge bracket global prime firms.

Interestingly, there was not a major change in the Canadian prime brokerage landscape as mini-primes did not have the same impact on the Canadian market as they had elsewhere.

The steady and prudent approach by Canadian regulators before, during and after the crisis put Canada in the enviable position of being a leading example to the rest of the world in providing sound markets and stable financial institutions for managers and investors.

RBC Capital Markets Prime Brokerage maintained a solid service offering throughout the crisis and continues to grow and adapt to the changes in the current market environment, all the while preserving the integrity and reputation of Canada's capital markets. ■

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# HOW TO CONVERT TO A NEW PROVIDER

THERE IS TREMENDOUS VALUE IN OUTSOURCING THE FUND VALUATION AND UNIT-HOLDER RECORDKEEPING FUNCTIONS OF INVESTMENT FUND MANAGEMENT, PARTICULARLY WHEN COMPARED AGAINST PERFORMING THESE FUNCTIONS 'IN-HOUSE'. DENNIS MACPHERSON OF SGGG FUND SERVICES INC EXPLAINS HOW, WITH THE RIGHT VENDOR, CONVERSIONS CAN BE COMPLETED QUICKLY WITH MINIMAL DISRUPTION

## Dennis MacPherson

is the vice-president, unit-holder recordkeeping and transfer agency at SGGG Fund Services Inc. He has many years of experience in investment fund operations at several leading firms. He is established as an industry leader in process improvement change as a member or chair of several committees and working groups.

### MAKING THE MOVE: WHAT'S INVOLVED

The process of converting to a new provider most often seems daunting at best. There is, after all, a lot involved and a lot at stake. The good news is any firm worth converting to is likely to be extremely good at managing the project; their survival depends on it.

Your first step is simply to initiate the discussion. This should be easy to do; if not, it could be a sign of things to come. A prospective administrator should be responsive to your inquiries and have the respect to thoroughly understand your business model before asking about your AUM. You will want to have reviewed your current service agreement contracts so you are clear on the scheduled end date, any renewal terms, termination clauses and, most importantly, what the required notice period is for non-renewal.

The prospective provider should perform a thorough review of the funds' offering documents to ensure there are no technology or business process gaps; the manager should disclose any customised items in this regard. Look to firms that have focus on administration and customer service and employ external specialised strategic partner firms to support their business objectives. Promises made at the outset are rarely realised after six to 12 months have passed and four different individuals or teams have pushed the manager along the 'production line'.

### FEE 'FOR SERVICE': WHAT'S INCLUDED

Before signing any agreement there should be written acceptance of a fee schedule proposal. Examine the structure and size of the prospective vendor; you may be paying for an immense overhead and massive middle office layer, neither of which add any value – only cost – to your business. Be absolutely clear on exactly what services are included and how they will be performed.

### BOTTOM LINE

For some it may be tempting to have all services with one firm. After all, this means only one invoice each month, only one external relationship to maintain. There is, however, something to be said for having multiple vendors with a piece and therefore constantly competing for all your business has an interesting way of keeping everyone honest.

### WHY SGGG-FSI?

- **Experience:** Established in the fund administration business since June 1997. With more than 250 alternative strategy funds under administration worldwide, our team provides administration services to

virtually every type of fund structure and strategy.

- **Personal service:** Although the worldwide SGGG-FSI team stands behind each client, the team members assigned to each client are dedicated to providing the highest levels of personal service.
- **Flexibility:** We pride ourselves on our ability to tailor our services to meet the needs of each individual client and respond quickly as our clients' needs evolve.
- **Value:** Fees can be structured to minimise expenses while managers build assets under management.
- **Independence:** A critical concern for investors, SGGG-FSI is not owned by or affiliated with any other fund service provider.
- **Technology:** Continuous investment in proprietary software allows us to meet the growing needs of our clients cost effectively. For fund managers, a portfolio management system was introduced in October 2008.
- **Security:** Our data protection and robust disaster recovery plans, combined with the support of the worldwide SGGG-FSI team, ensures that our clients are able to maintain secure business processing through all contingencies.
- **FundSERV network:** A cost effective way for alternative strategy funds to tap into the \$660bn Canadian retail system.
- **Locations:** Toronto – established June 1997; Cayman Islands – established October 2007; Malta – established August 2008
- **The result:** Accurate, timely administration with no surprises.

## ABOUT SGGG FUND SERVICES

SGGG Fund Services Inc. (FSI) has been providing third-party fund valuation & accounting and unit-holder recordkeeping & transfer agency administration outsourcing services to investment fund managers since 1997. We offer fund services worldwide through our Toronto head office, our international offshore affiliate offices in Cayman and Malta, as well as our affiliate proprietary portfolio management system technology.

FSI has more than \$6bn in AUA from our more than 100 individual clients, and services in excess of 250 different fund products. This has enabled us to develop a sophisticated understanding of our clients' needs; we act as a true administrative partner, allowing fund managers to focus on managing their portfolios.

# INCONVENIENT TRUTHS, CONVENIENT SOLUTIONS

ERIC SPROTT AND JAMES FOX OF SPROTT ASSET MANAGEMENT TALK TO *HFMWEEK* ABOUT THE TRUE STATE OF THE ECONOMY, AND HOW CANADA CAN CAPITALISE ON ITS ADVANTAGES



**Eric Sprott** is the founder and CIO of Sprott Inc. He leads a team comprised of the top investment professionals in Canada, who together manage over \$10bn in mutual funds, hedge funds, and structured products.



**James Fox** is president of Sprott Asset Management LP, the fund management arm of Sprott Inc. He plays an instrumental role in strategic business initiatives at the firm as well as increasing brand awareness both in Canada and globally.

In the wake of some of the most devastating financial crises in recent memory, there are now more and more confident claims in the media that the financial system and economy is on the mend with the 'wild west' days far behind. However, these problems may still be as pertinent as they were in the first instance, regardless of new regulation and transparency efforts. Eric Sprott and James Fox give their view on the true state of the economy, from a Canadian perspective, and which investment routes in their opinions offer the most solid bridges to financial security to once again.

**HFMWeek (HFM): In your opinion, what is the true state of the financial system? Do you have faith in the central banks and governments handling it?**

**Eric Sprott (ES):** As I see it, the current banking system is over-leveraged. At a minimum, banks are levered 20 to 1, so they have five cents of capital for every dollar of paper assets they own. If the value of those paper assets declines by 5% – they have no capital left. Imagine a Greek bank today: their government's bonds are down 50% and the stocks are probably down 30-40%. There is no way that they have any capital left. And bank deposits are leaving as a result. The same is true in Portugal and Spain, now moving over to Italy and of course everyone knows it. Therefore the sovereigns have to stand in and either buy something from the banks or provide exceptional lending to them.

This has been going on now since 2008. When Iceland's banks went broke, their government got involved. UK, Greek, US banks went broke, their governments all got involved. So now you've transferred what should have been the private risk to sovereign risk – and of course people are starting to question the sovereign risk because *there is no buyer*. That to me is the fundamental problem that we are facing today. If it does not solve itself, we will suffer a major financial crisis which would likely end up in a depression.

**HFM: In terms of investment strategies, what are the most viable opportunities for investors at present?**

**ES:** Well, back in 2000 we realized there was going to be a crash in the Nasdaq because there was a mania. I did a little soul searching, and asked myself 'how do we survive a secular bear market that is going to last a long time?' And I thought it would last 15-18 years back in 2000. We are still in such a market as far as I am concerned. And history has proven that the only assets that really survive a bear market are tangible things that are fungible. That's what led me to precious metals and perhaps agricultural land and other things where demand is relatively inelastic. So I am of the opinion that people have

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to have a hugely disproportionate amount of their portfolios in precious metals. As an example, of all the funds that I have run, at least 75% are in precious metals. And I don't lose any sleep over it. In any metric you look at, the data keeps telling you to move into precious metals. So we have been seriously involved in both the bullion and the stocks. I'm kind of favouring the stocks now more than bullion because the stocks haven't reacted as well as bullion. This gives us huge opportunities to prosper in the gold and silver equity areas. I prefer silver to gold as I feel silver will outperform gold. I have very often made the comment that gold is the investment of the last decade, which it certainly was, and silver will be the investment of this decade. I disfavour anything

related to financials. I did a chart the other day where I compared the performance of gold stocks versus bank stocks in the US. For the first seven weeks of the quarter the outperformance was 49%. *In seven weeks.*

**HFM: What can you see the next twelve months holding for the economy and the financial system? Can you see a campaign of deleveraging happening soon?**

**ES:** It is almost impossible to deleverage today because for an individual to pay off their loan it is a long, slow process. And obviously in the financial system it is hard to sell anything these days. There is really no net new buyer. All financial institutions have sustained leverage problems so I don't see it resolving itself.



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In terms of the economy, I refer to what the CEO of Walmart said three months ago; “our customers are running out of money.” It’s interesting that the best hour of sales for Walmart is from 12:01am to 1:00am at the start of the month, because everyone gets their government cheques. And as he said, as the month goes on the discretionary spending declines. All signs point to weakness, and we have had some awful numbers in terms of consumer confidence. It also looks like China is going to slow things down, which isn’t that surprising – who are they going to sell their products to? Who is going to be buying things, when, lets face it, our GDP growth was terrible in the last two quarters, all of European forecasts are moving down, as are the US, and you can’t sell more to a guy who’s GDP is going down?

**HFM:** Even though the Canadian hedge fund industry is still relatively in its infancy, how can it capitalise on its resource strengths?

**James Fox (JF):** I believe the hedge funds in Canada do have a unique advantage in resources due to the fact that we’re located in the centre of global mining finance. Last year, of the \$30bn of equity capital raised for mining globally, about 60% of that was raised here. That is definitely a real edge for the Canadian

hedge fund industry. Size and reputation helps too, and I would say our foyer at Sprott has become one of the busiest in the world as far as management teams and resource companies coming through, which we use to evaluate as many opportunities as possible and generate favourable terms for our investors.

**HFM:** Much of investor capital in Canada derives from high-net worth individuals, how can Sprott facilitate the growing interest from institutional investors?

**JF:** I think given the events that have happened in the hedge fund industry in the last several years, there is an increased emphasis on operational structure. Being

a larger firm with a robust operational and compliance platform has definitely given us an advantage in the Canadian market.

I think we’re also seeing some of the mid-tier Canadian institutional allocators beginning to look at alternatives. Over the past ten years or so, the major global institutional allocators based in Canada have already gone there, but the next step is to get the tier below them involved in hedge funds. This is a trend we’re noticing more and more, and we have to do what we can to facilitate that.

**HFM:** What strengths does Canada hold as a domicile for investment from an international perspective?

**JF:** If you are an international investor having a diverse portfolio of managers, I think you’re missing out if you don’t have Canada as an allocation. If you look at total quoted market value of listed companies as of 2010 year-end the \$2.3trn on the TSX and TSX venture is right up there with the \$3.6trn on the LSE and AIM exchanges. The ASX is around \$1.5trn and Hong Kong is around \$2.7trn, so as a part of the global exchange, Canada has plenty of comparable depth.

**HFM:** What can you see the next twelve months holding for Sprott and inflows into Canada?

**JF:** I do think that global markets, purely by looking through our macro view, will have to deal with the developed world increasingly debasing their currencies. As that continues to unfold, investors will look to hard assets as a way to preserve their capital. In our view this will bode well for the Canadian hedge fund space as allocators look to us to gain that exposure.

**HFM:** Can you see any challenges in the future?

**JF:** I would say for us a risk is that Canadian managers get labelled as resource-only investors. I always like to point out that we at Sprott had not been big resource investors in the 1980s and 1990s, and generated a record of around 25% a year during that time, similar to our record during this resource bull market. So while we obviously want to capitalise on our edge in the resource market, we always have to look at and adapt to various market environments and be willing to be opportunistic in our approach. ■

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# RAISING CANADA'S PROFILE

THE SCOTIA CAPITAL CANADIAN HEDGE FUND PERFORMANCE INDEX HELPS BOTH MANAGERS AND INVESTORS COMPARE FUND PERFORMANCE AGAINST TRADITIONAL INDICES AND GLOBAL COUNTERPARTS

<sup>TM</sup> Trademark of The Bank of Nova Scotia. Scotia Capital is the marketing name used in association with the global corporate and investment banking and capital markets businesses of The Bank of Nova Scotia and its various subsidiaries in the countries where they operate. Past performance of indices is not a guarantee of future performance.

**L**aunched in 2005, the Scotia Capital Canadian Hedge Fund Performance Index was designed to heighten the Canadian industry's profile and give both managers and investors a useful yardstick to measure the relative performance of individual funds against both traditional market indices, and their global fund counterparts. The Index has now grown from 24 funds to 58, and assets have more than tripled from \$2.6bn to nearly \$9bn.

"Five years ago, the Canadian landscape was dominated by traditional long/short equity managers," notes

Les Marton, managing director of Scotia Capital's hedge fund consulting group. "More recently, Canadian managers have been finding new and innovative ways to generate alpha for their domestic and global investors."

This has helped Canadian managers generate higher returns than traditional equity indices with a fraction of the volatility.

Based on most recent data to July 2011, the Index has generated an annual return of 11.32% since inception. This rate compares to less-than-stellar returns of only 5.24% for the TSX Composite, and 0.98% for the S&P 500 for the comparable period. ■

## HISTORICAL MONTHLY PERFORMANCE



### INDEX SUMMARY

*Month end July 2011	Value	Return MOM	Return YTD	Annualised return**	Annualised standard deviation***
SC CDN HF Performance Index Asset Weighted	2,026.03	3.39%	-0.82%	11.32%	11.83%
SC CDN HF Performance Index Equal Weighted	1,560.58	1.57%	-2.09%	6.99%	9.92%
S&P TSX Composite	12,945.63	-2.67%	-3.70%	5.24%	15.69%
S&P 500 (quoted in USD)	1,292.28	-2.15%	2.75%	0.98%	15.95%
S&P 500 (CAD-adjusted)	1,234.39	-2.98%	-1.65%	-2.43%	11.88%
DEX 91 Day Treasury Bill Index*	385.39	0.07%	0.59%	2.43%	0.47%
DEX Universe Bond Index**	820.58	2.04%	4.29%	5.63%	3.34%

\*All returns quoted in CAD except where indicated

\*\*Compound annual returns since index inception (31 December 2004)

\*\*\*Of monthly returns

\*Formerly: Scotia Capital 91 Day Treasury Bill Index

\*\*Formerly: Scotia Capital Universe Bond Index

# *Advice into action*

**pwc**

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At a time when hedge fund assets are returning to growth, investors, regulators and tax authorities are making tighter controls and stronger governance the price of future success. For those that rise to these challenges, there is potential reward.

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