

December 24, 2002

British Columbia Securities Commission
Alberta Securities Commission
Saskatchewan Securities Commission
Manitoba Securities Commission
Ontario Securities Commission
Securities Administration Branch, New Brunswick
Office of the Attorney General, Prince Edward Island
Nova Scotia Securities Commission
Securities Commission of Newfoundland and Labrador
Registrar of Securities, Department of Justice, Government of the Northwest Territories
Registrar of Securities, Government of Yukon
Registrar of Securities, Legal Registries Division, Department of Justice, Government of Nunavut

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- and -

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Re: Proposed National Instrument 81-106 – Investment Fund Continuous Disclosure

General

Canadian members of the Alternative Investment Management Association (“AIMA”) appreciate the opportunity to offer comments with respect to the Canadian Securities

Administrators (“CSA”) proposed National Instrument 81-106 Investment Fund Continuous Disclosure (“NI 81-106”).

AIMA was established in 1990 as a direct result of the growing importance of alternative investments in global investment management. AIMA is a not-for-profit educational and research body that specifically represents practitioners in hedge-fund, futures fund and currency fund management- whether managing money, providing a service such as prime brokerage, administration, legal or accounting. AIMA’s global membership comprises over 470 corporate members including many of the leading investment managers and professional advisors.

One of the objectives of AIMA is to ensure the representation and integration of skill-based investments into mainstream investment management. AIMA works closely with regulators and interested parties in order to better promote and control the use of alternative investments.

This response has been prepared by a working group of Canadian members of AIMA comprised of hedge funds, fund of funds and accountancy and law firms with practices focussed in the alternative investment management sector.

Organization

This letter sets out a brief overview of our general thoughts concerning NI 81-106 and, through our responses to the specific questions raised by the CSA in its Request for Comment on NI 81-106, highlights some of the more significant areas of concern.

Overview

Although the comments set out in this letter address the more general “investment fund” universe, we feel that our comments are particularly salient to private hedge funds and private “fund of fund” hedge fund structures offered to accredited investors and other exempt purchasers who are deemed by applicable securities laws to have a sophisticated level of knowledge in order to permit them to make and/or evaluate their investment decision. Although we recognize that private funds are exempt from a number of the provisions of NI 81-106, the issues discussed below relating to the compressed time periods for the preparation of the quarterly financial statements of “public” mutual funds are also generally applicable to private funds in the context of their semi-annual financial reporting requirements.

In many cases, privately offered hedge funds and fund of funds may not be able to comply with the compressed reporting timeframes because of the nature of the instruments traded and, in some cases, the investment by domestic hedge funds in hedge funds located outside of Canada which are not subject to such reporting timeframes. Furthermore many private hedge funds and fund of funds could be negatively impacted by revealing portfolio positions to other market participants and competitors who could use that information to the detriment of the disclosing fund. Overall, we question

whether it is in the best interests of the security holders to create rules that apply to all investment funds when the strategies and approaches taken by hedge funds are fundamentally different from “long only” mutual funds. The unintended result of the disclosure proposals contained in NI 81-106 may be to cause some domestic hedge funds to migrate their funds to jurisdictions outside of Canada.

Responses to Specific Questions of the CSA

Question 1: Management Reports of Fund Performance

The CSA invite comments as to whether the quarterly management reports of fund performance will achieve the goals that they are intended to achieve. Should there be more or less frequent disclosure of fund performance information and why? Should there be quarterly reporting for all investment funds? Does the proposed type of information allow an investor or an adviser to make informed investment decisions?

Response:

The management discussion of fund performance (“MDFP”) envisioned by NI 81-106 would consist of quantitative and qualitative information concerning the investment fund, presented in a concise and plain-language format. We support the idea of the dissemination of easy to understand, summary information to security holders who elect to receive it. However, we do not believe that the quarterly reporting envisioned by NI 81-106 would provide security holders with information that would be useful to them in the context of making or evaluating their investment decision.

Marginal Utility of Financial Statements to Average Investors

The purpose of the quarterly reporting requirements of NI 81-106 is to provide more timely and useful ongoing financial information about investment funds to investors and advisors. We question the utility of financial statement information to the average Canadian investor. We believe that the majority of investors do not read financial statements in detail and that other measures such as the net asset value (“NAV”) of the fund (which is calculated and published on a daily basis for most investment funds) is a far more meaningful barometer to investors in evaluating their investment.

We believe that the objectives of NI 81-106 would be advanced more efficiently through a focus on improving the quality (as opposed to the frequency) of information that is made available to security holders. We believe that the focus of MDFP should be the information that is most relevant to investors when they evaluate their investments, namely: (i) a statement of the fund’s rate of return and management expense ratio; and (ii) a brief commentary from management of the fund on the results of operations and future prospects.

Timing Constraints for Preparation of Quarterly Reports

The quarterly reporting obligations required by NI 81-106 would be particularly onerous and, in some cases, impossible to adhere to for publicly offered fund of funds arrangements in the alternative investment area. In the case of fund of funds structures, the underlying funds may or may not be subject to the same quarterly reporting requirements as the public fund. Furthermore, the various underlying funds which comprise the fund of funds could have different year-ends. This could make the preparation of quarterly reports, in some cases, impossible to complete within the time limits proposed by NI 81-106.

In our view, the utility of quarterly financial reporting, when weighed against current practices such as daily publication of NAV, the continuous reporting requirements of NI 81-106 and the costs and difficulties of compliance, is marginal at best.

Quarterly Reporting Encourages a “Short-Term” Mind Set Amongst Investors

An additional problem we see with the quarterly disclosure requirement is that it shifts the focus on performance to a short-term as opposed to a longer term mindset. The increased frequency of disclosure contemplated by NI 81-106, particularly the disclosure of a fund’s portfolio holdings (discussed below), could serve to undermine investor perception and behaviour in a manner that is entirely inconsistent with the original rationale for their investment, possibly leading to higher levels of redemptions if a mutual fund is considered to have “under performed” in a particular quarter. This could also result in investment managers, either consciously or sub-consciously, altering their investment techniques to emphasize short-term as opposed to longer term gains.

Costs of Compliance with Quarterly Reporting Requirement

Costs in the investment fund industry are always a sensitive issue as mounting costs are invariably passed on to investors in the form of increased expenses charged to the fund. We anticipate that there will be significant increases to the costs incurred by investment funds in the preparation (eg. staff and legal costs), translation, printing and delivery of quarterly MDFP. These new costs will reduce (and may even eliminate) the potential cost savings that may accrue from permitting investors to elect whether or not they would like to receive an investment fund’s financial statements/MDFP, thereby diminishing one of the goals (cost savings) which the CSA had hoped to confer in NI 81-106. These added costs will be borne by all mutual fund investors and could act as a drag on fund performance.

Potential for Abuse of Quarterly Reporting of Portfolio Holdings by Fund Outsiders

In the realm of publicly traded hedge funds, more frequent disclosure of fund portfolio holdings could also facilitate practices which could prove to be harmful to the interests of both investment funds and their security holders. Quarterly disclosure of a fund’s portfolio holdings will encourage fund outsiders to engage in the practices commonly known as “front-running” (anticipating fund trades and trading in securities ahead of the investment fund) and/or “free-riding” (building a portfolio which is the same as that

disclosed by the investment fund). These practices may result in higher prices for the securities purchased by the hedge fund, lower prices realized on the sale of securities by the fund and allows fund outsiders to achieve the benefit of professional investment management and research which is paid for by the security holders of the hedge fund.

Effect of Reporting of Portfolio Holdings on Private Hedge Funds

We believe that the proposed requirement in NI 81-106 for disclosure of portfolio holdings in a fund's interim and annual financial statements would have an adverse effect on private hedge funds due to the fact that, in many cases, the strategies employed are based on proprietary research which is often reflected in the securities purchased. Requiring disclosure of a private hedge fund's portfolio holdings in the manner contemplated by NI 81-106 would require the managers of such hedge funds to reveal investment allocations and, over the course of time, show trends in trading practices which could negatively effect their ability to pursue these strategies on a going forward basis. This is already an area of concern to the industry with the currently existing semi-annual and annual reporting. In addition, it is unclear as to how the proposed disclosure of portfolio holdings would apply to private fund of funds hedge funds where some (or all) of the underlying hedge funds within the fund of funds are formed outside of Canada and therefore are not subject to the same disclosure requirements for their portfolios. The reporting of portfolio holdings by Canadian hedge funds would be unique on the international landscape and would prejudice Canadian hedge funds and their investors relative to other funds established outside of Canada.

Question 2: Financial Statements

The CSA invites comment on whether the financial statement requirements set out in the proposed Rule meet the needs of the users of the financial statements? Does the amount of detail provided in the proposed National Instrument assist with the preparation, consistency and comparability of the financial statements? Is the proposed National Instrument too detailed? Is more detail or specific direction necessary?

The majority of investment funds currently prepare and file six-month interim financial statements. Should all investment funds be required to prepare and file quarterly financial statements in addition to the proposed quarterly management reports of fund performance?

Response:

NI 81-106 includes proposals to shorten the time periods for the filing of annual financial statements from 140 to 90 days after year-end and for interim financial statements from 60 to 45 days after the end of the interim period. For the reasons set forth under our response to Question #1 above, we do not think that public investment funds should be required to prepare and file quarterly financial statements. We would support semi-annual as opposed to quarterly reporting for all publicly-offered investment funds. We

believe that semi-annual reporting will achieve the principal goals of NI 81-106 while, at the same time, avoiding the pitfalls of quarterly reporting discussed above.

The preparation of financial statements is a time intensive endeavour which requires a coordination of efforts from a wide variety of inputs (especially in the fund of funds context). In our experience, the process of preparing financial statements is already difficult under the existing deadlines and will become even more so with the shortened time periods contemplated by NI 81-106. In particular, several members have indicated that it will be physically impossible for them to meet the proposed 45-day deadline to file interim financial statements.

It is apparent from our perspective that the CSA expect the industry to address these issues through a re-engineering of our existing process for the preparation, review and delivery of financial statements. We encourage the CSA to recognize that the process of preparing, producing and delivering financial statements (especially for smaller hedge funds) is a significant undertaking and that several aspects of this process are not within the control of the investment fund.

We support financial statement disclosure which is based on and adheres to the concept of materiality. The mandated use of financial statement line items may not be appropriate for all types of funds and may not provide a useful measuring stick in comparing different investment funds. The goal of financial statements should be the provision of information which is meaningful and relevant for each particular investment fund. We do not believe that the line items mandated by NI 81-106 achieve this goal.

We have the following specific comments on some of the additional line items proposed by NI 81-106 for financial statements:

(i) the inclusion of “waived expenses” within the Statement of Operations (section 4.3) should be removed as they are not part of a fund’s results and should be addressed in the notes to the financial statements instead;

(ii) presumably the proposed Statement of Cash Flows (section 4.2) will replace the existing Statement of Net Realized Gains. We question the reason for this change as our belief is that Statement of Cash Flows is not meaningful for investors in a fund as a financial entity;

(iii) the inclusion of performance fees within the management expense ratio (section 7.4) is not appropriate and can be misleading to investors. A performance fee is only obtained when a fund has positive performance as opposed to a management fee which is applied notwithstanding performance. A fund which has very strong net performance will, by definition, have a higher management expense ratio (due to the inclusion of the performance fee). We question whether investors reviewing the listing of management expense ratios in a newspaper or other reporting services will understand this distinction. We strongly believe that there should be proper disclosure of performance fees but that this disclosure should be accomplished as a separate item.

(iv) references to “net asset value” in NI-106 do not work for hedge funds that contain long and short positions. Long positions and short positions should be treated separately.

Question 3: Disclosure of Risk and Volatility

The CSA invite comments on whether alternative methods of disclosing risk and volatility should be used. For example, should there be disclosure of the fund’s best and worst quarter returns or disclosure of the correlation of the fund to a benchmark index? Is there additional disclosure that would provide useful information to the investors and advisers?

In the experience of our members, discussions of risk and/or volatility are inherently problematic, generally misunderstood and may not provide a useful tool in comparing investment funds for the average investor. More importantly, there is no generally accepted standard or consensus as to the best measures of risk and volatility given the wide variety of investment strategies and techniques employed by hedge funds and fund and funds. We believe that the mandatory discussion and/or disclosure of risk and volatility could be potentially misleading and would not materially assist investors in making or evaluating an investment decision.

Conclusion

We appreciate the opportunity to provide the CSA with our views on this proposal. Please feel free to direct any questions or comments that you might have to any of the following members of our working group:

- Jim McGovern, Arrow Hedge Partners Inc. (416) 323-0477
- Ian Pember, Hillsdale Investment Management Inc. (416) 913-3920
- Henry Kneis, Abria Financial Products Ltd. (416) 367-9992
- Gary Ostoich, McMillan Binch LLP (416) 865-7802

Yours truly,

“Michael A. Burns”

Michael A. Burns

cc: Raymond Chan – Accountant, Investment Funds Capital Markets Division, Ontario Securities Commission