

**Excerpts from an
address by
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to**

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Strategies for a Volatile World

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Importance of Strong Advisors

Recent Investor Statistics 2006-2007:

In October 2006, CSA Investor Education Committee released the results of the first Investor Index conducted nationally (available on CSA website). The survey consisted of telephone and online surveys and was administered to over 5,000 Canadians.

Some of the results observed were:

- Many Canadian investors lack key investing tools.
- Although Canadians say having a plan is important, 58% report they do not have a financial plan with clear investment goals and 55% do not have regular financial advisers. However, among those Canadians who hold stocks, bonds and mutual funds, 86% say they understand how risky each of their investments are today and 62% have reviewed the level of risk they are prepared to take with their investments within the last year.
- Canadians show moderate levels of investment knowledge.
- Canadians show moderate levels of investment confidence.
- Canadians produce mixed performance when it comes to taking appropriate precautions in their investment decisions.
- Of concern, was the finding that most Canadians do not seek out regular financial advice from professionals.

- 55% of Canadians have no regular financial adviser.
- When asked how they became aware of their most recent financial investment, 44% of Canadian investors responded they had been approached directly by someone with the opportunity. Roughly the same number of investors responded that they had come across the opportunity on their own. 72% of those that reported being approached by someone for their last investment opportunity identified that someone as their regular financial adviser or stock broker.
- 42% of Albertans have a financial plan that includes clear investment goals, and 60% report being familiar with their most recent investment and could explain the risk and benefits to someone else in detail (compared to national stats of 38% and 53% respectively).
- Albertans are most likely to personally research their investments (57% as compared to 48% nationally) and invest in opportunities only after taking time to think about it (72% compared to 65% nationally).

Role of Advisor:

It is essential to the efficient working of our disclosure based securities regulatory regime in Canada that investors have high quality investment advice readily accessible to them, that they know where to find it, that it be priced fairly for the value delivered and that it be comparable in respect of both quality and price.

Regulation of Alternative Products:

a) Hedge Funds:

Hedge funds have been heralded as the fastest growing segment of Canada's capital markets and are praised for increasing the depth and breadth of markets and creating new investment strategies. As hedge fund popularity grows, so do concerns that hedge funds are only minimally regulated. Concerns relate to:

- transparency
- how to judge suitability
- short selling
- securities lending
- short term goals
- democratic voting control

The CSA recently performed a detailed analysis of hedge fund regulation, or perceived lack thereof, and concluded that the current regulatory regime is appropriate, although certain concerns remain.

Increased regulation is a controversial mechanism suggested for increasing disclosure by hedge fund

managers. While increased regulation is regarded as a good thing from an investor protection stance, its benefits diminish markedly if such regulation interferes with the flexibility and creativity that is characteristic of hedge fund managers and the success of the funds. It is appreciated that one of the major incentives to investing in a hedge fund is the unique investment strategies utilized by fund managers.

On January 12, 2007, the CSA issued Staff Notice 81-316 *Hedge Funds*, which sets out the results of the CSA sample-based hedge fund review which was conducted throughout 2005 and 2006 in recognition of the increasing popularity of hedge funds and the resulting issues concerning hedge fund regulation, or perceived lack thereof. For the purposes of their review, the CSA defined hedge funds as “investment pools that use alternative investment strategies not generally available to traditional mutual funds such as taking both long and short positions and using arbitrage, leverage, options, futures, bonds and other financial instruments to capitalize on market conditions.”

Focusing on issues such as the safeguarding of client assets, valuation process, marketing materials and offering documents, the extent and type of fees being charged, product liquidity, referral arrangements, and product distribution, the CSA reported as follows:

- *Custody* – Client assets were held in safekeeping predominantly by large, reputable third parties such as banks, dealers and trust companies.
- *Valuations* – Valuations for hedge funds were performed on a reasonably frequent basis (weekly, bi-weekly, monthly) either in-house or by third party service providers. When valuations were performed in-house, automatic price feeds from various external sources were used to minimize the risk of pricing errors. When valuations were outsourced, the only issue noted was that many of the market participants did not maintain evidence of their oversight review of the funds' calculation of net asset value (NAV).
- *Marketing* – We had concerns about the presentation of performance returns and inadequate or inaccurate disclosure in some of the marketing materials we reviewed. In some cases, actual performance returns were presented together with simulated back tested data and disclaimers accompanying these types of performance presentations were weak.

- *Fees* – The reviews revealed that there are multiple layers of fees in hedge funds, including management fees, performance fees, up-front sales fees, trailer fees, and early redemption fees. In the case of funds of hedge funds, there is an additional layer of management and performance fees. While the fees associated with these products were disclosed in the offering documents, we had concerns with the clarity of the disclosure, the fact that the disclosure of various fees often appeared in many unrelated places in the documents and not on a consolidated/summary basis, and with the transparency of the overall levels of fees.
- *Exempt offering disclosure* – While we found that the product disclosure covered information similar to prospectus-level disclosure, there was a lack of consistency in the presentation of information. Given that these are complex products with layered structures and multiple fees, this made the disclosure difficult to understand and compare across products.
- *Liquidity* – The majority of the hedge funds reviewed in our sample that were sold in the exempt market allowed for weekly or monthly redemptions at NAV. Prospectus qualified funds were traded daily on the exchange.
- *Referral Arrangements* – We noted certain issues relating to referral arrangements in Ontario and British Columbia. In Ontario, there was an instance where a registrant inappropriately delegated its responsibility to supervise trades and assess the suitability of trades for its client to a non-registrant. The written agreement between the registrant and non-registrant did not clearly set out the roles and responsibilities of each party, including who was responsible for disclosure of the

referral arrangements to clients. In British Columbia, there was an instance relating to inadequate disclosure of conflicts of interest. These instances were not representative of the population.

- *Distribution* – During the compliance reviews, we found that hedge funds and principal protected notes (PPNs) were frequently distributed through investment dealers and mutual fund dealers. In British Columbia and Quebec, the majority of hedge funds were distributed by the funds' portfolio managers.

CSA staff concluded that our regime contains an appropriate securities regulatory framework for hedge funds, but that certain areas within it could be improved. In particular, CSA staff identified PPNs, referral arrangements, distribution, registration and oversight of fund managers, disclosure, and financial disclosure and valuation as “areas of concern”. I will discuss PPNs further in a moment.

With regard to distribution, CSA staff advised, “Dealers should ensure that they and their salespersons have sufficient proficiency and product knowledge of these very complex products to adequately assess suitability of the products for their clients. The dealer SROs should monitor that dealers and their salespersons are performing

reasonable know your client and suitability assessments in the distribution of hedge funds.”

With regard to registration and oversight of fund managers, CSA staff acknowledged, “fund managers need not be registered unless they are also managing portfolio assets, in which case they must be registered as advisors” and alluded to the Registration Reform Project and the proposed registration requirement for fund managers. In addition, CSA staff stated that they would consider continuing their compliance examinations of hedge funds, subject to available funding and overall compliance objectives.

We have elected to back away from new regulation focused on hedge funds and to rely on the rules already in place, but there is continuing strong pressure to do otherwise.

b) PPNs:

PPNs have been an area of concern for the CSA, and the CSA PPN Committee undertook a great deal of legal research and analysis on the issue. On July 7, 2006, the CSA issued Staff Notice 46-303 *Principal Protected Notes*

(PPN Notice), which outlined the CSA's concerns and called for further study.

The PPN Notice defines a PPN as “an investment product that offers an investor potential returns based on the performance of an underlying investment and a guarantee that the investor will receive, on maturity of the PPN, not less than the principal amount invested.” Market-Linked GICs and Linked Notes are examples of PPNs.

The PPN Notice raises the following concerns with respect to PPNs:

1. Disclosure – We are concerned that investors are not getting sufficient disclosure to allow them to make an informed investment decision. They are not getting sufficient disclosure about how PPNs are structured, how they work, and the fees and investment risks associated with them. Some of our more specific disclosure-related concerns are:

Disclosure documents and marketing materials

- Sales and marketing materials contained poor or overly-promotional presentation of performance returns. For instance, they provided

- disclosure about the potential upside return of the investment without providing sufficient information to allow an investor to understand how

much the underlying investments would need to return, after fees, to deliver the upside that is being promoted,

- “back-tested” performance returns to show what the performance would have been if the product had existed for a certain period of time without an explanation of why that particular period is being used and that the disclosure is essentially based on hypothetical performance, and

- performance information presented in an unbalanced way.

- Disclosure in information statements provided for many PPNs was lengthy, complex and difficult to understand, particularly in the sections describing the methods used to deliver principal protection and the upside benefit of the return on the linked investment.

- Disclosure materials in some cases lacked a sufficiently understandable description of the structure (both for the guarantee and the underlying investment) and the various participants that stand behind the investment.

Fees - We are concerned that investors might not be aware of the full cost they are paying, or that there is a cost at all, for the guarantee provided with PPNs. In some cases, that cost is the additional fees to cover the insurance policy to back the guarantee. In other cases, there are multiple layers of fees including management fees, performance fees, up-front sales fees, and trailer fees. These fees can significantly reduce the returns that would otherwise be derived from the underlying investments.

Lack of liquidity - We are concerned investors might not be aware that the terms of the PPN frequently do not permit an investor to sell it before maturity, without significant penalty. It also means that investors who wish to sell a PPN before maturity might not receive 100% of the principal amount invested.

2. Know your client and suitability obligations - Any registrant that sells a security, including a PPN that is sold under a prospectus and registration exemption, must comply with the know your client and suitability obligations. Clearly, the registrant must understand the PPN well enough to be able to assess its suitability for a client. We are concerned that some sellers of PPNs are not meeting these requirements.

3. Retailization of alternative investment products - We are concerned that some PPNs are being used as vehicles for retail distribution of, or exposure to, complex alternative investment products like hedge funds, funds of funds, or managed futures, without the general protections Canadian securities laws provide or sufficient disclosure to permit an investor to make an informed investment decision.

4. Referral Arrangements - Securities laws in some jurisdictions and some self-regulatory organizations have specific requirements for how registrants handle referrals to and from registrants. Even where specific requirements do not exist, registrants are still bound by their general obligation to act in the best interests of their clients. We are concerned that some registrants may be making a referral to purchase a PPN without concluding that the referral is in the best interests of their clients.

Given their concerns, CSA staff advised as follows:

- Any issuer that plans to offer a PPN should ensure that the accompanying disclosure documents and any sales and marketing materials are clear, comprehensive, balanced, and provide sufficient information for investors and their advisers to make informed investment decisions or recommendations.
- Any person planning to sell PPNs should satisfy itself whether its representatives need to be registered and, if so, are properly registered to sell those products. Any registered dealer should also ensure that its representatives have the appropriate training and that they have a thorough enough understanding of the PPN to be able to assess its suitability for a particular client. Any registered dealer and its representatives should assess their policies for ensuring that any PPNs they recommend to clients are suitable.

CSA Staff expect to release a further PPN Notice by the end of July 2007. The Federal Government is currently drafting PPN

Regulations, and it is expected that these federal regulations will apply to approximately 89% of market-linked notes and 41.9% of market-linked GICs. The CSA has been reviewing and commenting upon the draft federal regulations and anticipates that the finalized regulations, which are expected to be in force by January 1, 2008, will address the CSA's concerns with regard to PPNs.

c) Limited Partnerships:

Another alternative product that is causing concerns is in the area of limited partnerships.

The question is whether general partners of limited partnerships which are created for the purpose of investing in the securities of other issuers must be registered as advisors.

It is clear that limited partners are, and are required to be, totally passive and reliant on the general partner and that the

general partner is advising the limited partnership on investment selection.

It would be the conclusion of ASC staff that the general partner is in essence advising the limited partners on securities investment and must therefore be registered.

You should expect to see an ASC Notice on this subject in near future.

Exempt Market Dealer Registration:

The comment period to the proposed new Registration Rule NI 31-103 expired in June 2007.

After a likely second publication of the rule in the fall of 2007, the intent is to finalize the rule by end of 2007.

Related legislative amendments have been passed in Alberta and are awaiting proclamation.

One of the key features of the proposed new rule is the requirement for persons dealing in prospectus exempt securities to be registered.

Under the current regime, there is no such registration requirement in Alberta. This means there is no “know your client” obligation, no suitability obligation, no capital requirement, no insurance requirement and no record retention requirements.

The new Rule would require registration and compliance with related rules.

The proposed new rule would also cover general partners of limited partnerships, whether or not the limited partners were accredited investors.

The ASC is sensitive to concerns expressed over impact on province’s venture capital raising; however the Alberta position to date would support the imposition of minimum standards relating to integrity, financial viability, proficiency and conduct.

Through our consultations, we have been asked a number of times whether there is any disruption of the market through the

exempt category. I can advise that of the 269 new files opened by the ASC Enforcement Department between April 1, 2006 and March 31, 2007, 86 or 32% were exempt market matters and of the 418 open files in the Enforcement Department that were worked on during that same time period, 134, again 32%, were exempt market matters. So the answer is “yes, there is a significant disruption.”

Accordingly, the ASC would like to know who the players are and what they are doing. We are still working out the exact extent of registration related requirements to be imposed. Taking a practical approach, we are looking at things like business structure, capital, insurance, financial statements and record keeping.