Keeping Up with the Joneses: A Model Systemic Risk Reporting Regime for the Canadian Hedge Fund Industry

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The purpose of this paper is to suggest a regulatory model by which Canadian securities regulators may monitor the systemic risk contributed to by the Canadian hedge fund industry. The bases for this model are recent regulatory reform initiatives adopted in the U.S. and Europe. There, securities regulators have adopted Form PF and AIFMD, respectively, to monitor the systemic risk contributed to by hedge funds. However, the features of those regimes are not necessarily appropriate for the Canadian industry. The appropriateness of the features of Form PF and AIFMD for the Canadian hedge fund industry is evaluated on two criteria: the average industry fund size, and the cost of regulatory compliance. This paper identifies three features of Form PF and AIFMD that are appropriate for the Canadian hedge fund industry: a minimum size exemption, uniform reporting depth, and extensive data sharing.

L'objectif de l'auteur est de proposer un modèle de réglementation par lequel les instances réglementaires canadiennes en matière de valeurs mobilières pourraient surveiller le risque systémique auquel contribue l'industrie canadienne des fonds de couverture. Le modèle proposé s'inspire des récentes initiatives de réforme de la réglementation aux États-Unis et en Europe. Dans ces pays, les instances réglementaires en matière de valeurs mobilières ont adopté, respectivement, le Formulaire PF et l'AIFMD, pour surveiller le risque systémique auquel contribuent les fonds de couverture. Cependant, les caractéristiques de ces régimes ne sont pas nécessairement appropriées pour l'industrie canadienne. La pertinence des éléments du Formulaire PF et de l'AIFMD pour l'industrie canadienne des fonds de couverture est évaluée en fonction de deux critères : la taille moyenne des fonds et le coût du respect de la réglementation. L'auteur relève trois caractéristiques du Formulaire PF et de l'AIFMD appropriées pour l'industrie canadienne des fonds de couverture : une mesure d'exemption relative à la taille minimum, l'uniformité pour ce qui est des rapports et le partage de renseignements.

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Introduction

"In this day and age, one cannot take two steps on Wall Street without hearing the 'H' word. [...] What single sector could have possibly swept the financial world off its feet the way this one has?"

—Andreas Christofi et al.1

The need for and proper extent of financial regulation is a contentious topic. Indeed, financial regulation is typically frowned upon in our economic society, one built on a foundation of capitalism.2 Among the most debated regulations are those that relate to financial markets and securities. As they supervise and control financial markets and securities, regulators must strike a delicate balance between protecting vulnerable investors, promoting innovation, and facilitating market efficiency.

The global financial crisis of 2008 was a powerful catalyst for sweeping regulatory change. Beset by catastrophic losses in the highly regulated banking industry, regulators in many jurisdictions turned their attention towards financial markets and securities. Indeed, prior to the crisis, some securities were either lightly- or even un-regulated; regulators intended to correct these perceived deficiencies, whether a cause of the crisis or not. In response to the tidal wave of opinion calling for reform to financial markets and securities, regulators worldwide paid particular attention to a single class of financial product: hedge funds.3

Hedge funds are a tantalizing target for regulators worldwide; the funds, and those that manage them, are notoriously secretive and the subject of sensational media coverage. The staggering fraud perpetrated by the hedge funds run by Bernard Madoff, and the high-profile allegations of insider trading at Steven Cohen’s SAC Capital Advisors, LP are but two well-known examples of why hedge fund regulation has considerable political and economic resonance.4 More stringent oversight of the hedge fund industry, then, is touted as a means to improve the stability of the overall financial system.5

Not surprisingly, the approaches to hedge fund regulation reform are disparate amongst jurisdictions. Two recent reform examples are the

2. Ibid at 33.
hedge fund regulations imposed by the U.S. Securities and Exchange Commission (SEC) pursuant to the *Dodd-Frank Wall Street Reform and Consumer Protection Act*, and those imposed in Europe by the European Commission. Both of these regulatory reform initiatives include measures intended to monitor the systemic risk caused by the hedge fund industry. However, unlike the industries in the U.S. and Europe, the Canadian hedge fund industry has not been subject to significant regulatory reform.

By way of brief introduction, this paper surveys contemporary hedge fund regulation reform vis-à-vis systemic risk in the U.S. and Europe, and then suggests which features of those regimes may be appropriate for the Canadian hedge fund industry. However, before embarking on this examination of hedge fund industry regulation, it is first necessary to briefly explain what hedge funds are (and what they are not) and why they are consequential in terms of systemic risk.

1. *The long and short of hedge funds*

Hedge funds are notoriously difficult to define. Indeed, a categorical definition of hedge funds is noticeably absent from securities legislation and regulations. For example, none of the thirteen provincial or territorial securities statutes or accompanying regulations includes a definition. This is so because, as some commentators suggest, hedge funds cannot be defined—that is, hedge funds are not homogeneous entities. They do, however, share some common characteristics.

The SEC recently described hedge funds by comparing them with mutual funds. Although the description is purposefully vague, it does provide a convenient starting place for understanding hedge fund characteristics:

Hedge funds typically have more flexible investment strategies than, for example, mutual funds. Many hedge funds seek to profit in all kinds of markets by using leverage (in other words, borrowing to increase investment exposure as well as risk), short-selling and other speculative investment practices that are not often used by mutual funds.

This description highlights several characteristics of hedge funds, namely that they involve sophisticated strategies that take long and short positions,

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and that they are typically leveraged (as will be discussed). These characteristics make hedge funds a volatile, high-risk form of investment.

The Canadian Securities Administrators (CSA) has also had occasion to describe hedge funds. The CSA also described hedge funds by comparing them with mutual funds. As above, the CSA attempt at definition is purposefully broad:

[I]nvestment 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.

This definition adds to the SEC description by highlighting that hedge funds tend to use arbitrage to exploit market inefficiencies. Intuitively, this focus on exploiting market information by hedge fund managers may lead to instances of insider trading.

Another recognized characteristic of hedge funds is their fee structure. A common fee structure is the so-called “2 and 20 rule” whereby managers charge 2 percent of assets under management (AUM) and 20 percent of profit as a performance fee. And while this structure is not atypical of the broader fund management industry, depending on the performance and reputation of a hedge fund, fees can skyrocket; in the case of Steven Cohen’s SAC Capital Advisors LP hedge funds, the structure was reportedly as high as “3 and 50!”

The SEC and CSA descriptions highlight several common hedge fund characteristics. In general terms, hedge funds are pooled investments that involve alternative investment strategies using both long and short positions, are typically leveraged, use arbitrage, and have moderately aggressive fee structures. It may come as a surprise, then, that hedge funds were not the subject of direct regulation until very recently; or rather, that they were able to benefit from numerous regulatory exemptions in some jurisdictions.

10. Christofi et al, supra note 1 at 25.
12. SEC, Hedge Funds, supra note 9 at 3.
13. PBS, “Frontline: To Catch a Trader” (7 January 2014), online: PBS <www.pbs.org/wgbh/pages/frontline/to-catch-a-trader> at 00h:08m:05s.
2. *The elephant in the room?*

"Growth of the hedge fund sector has been so explosive that it is truly unclear how large of an impact it has on the world’s, let alone the U.S.’s., investment decision-making."

—Andreas Christofi et al.\(^{14}\)

Regulators are keenly aware of the consequences of financial instability caused by systemic risk. In a 2009 joint report to the G20 Finance Ministers and Governors, the International Monetary Fund (IMF), Bank for International Settlements (BIS), and Financial Stability Board (FSB), all prudential regulators, described systemic risk as follows:

[Systemic risk] is the disruption to the flow of financial services that is (i) caused by an impairment of all or parts of the financial system; and (ii) has the potential to have serious negative consequences for the real economy.\(^{15}\)

Similarly, Brunnermeier, Gorton and Krishnamurthy describe systemic risk as "the risk that shocks affect the financial sector and trigger an endogenous adverse feedback significantly amplifying these shocks, causing further deterioration in the financial sector, and leading to significant output losses."\(^{16}\) Systemic risk, then, can perpetuate and even amplify adverse financial conditions across and between financial industries.

In the same report to the G20 Finance Ministers and Governors, the IMF, BIS, and FSB also described a conceptual model for assessing the degree of systemic risk associated with a particular financial industry or institution.\(^{17}\) And while other, more sophisticated models have been tabled since, this model provides an accessible and sufficient explanation of the nature of systemic risk for present purposes. In simple terms, the systemic importance of an industry or institution is a function of its size (in terms of number of participants or volume of transactions), substitutability, and interconnectedness.\(^{18}\) In other words, industries that perform many services that cannot be directly replaced by other market participants in the event

\(^{14}\) Christofi et al, *supra* note 1 at 25.

\(^{15}\) International Monetary Fund, Bank for International Settlements & Financial Stability Board, "Report to G20 Finance Ministers and Governors: Guidance to Assess the Systemic Importance of Financial Institutions, Markets, and Instruments: Initial Considerations" (IMF, BIS & FSB, October 2009) at 5-6, online: BIS <http://www.bis.org/publ/othp07.pdf> [IMF, BIS & FSB].

\(^{16}\) Markus K Brunnermeier, Gary Gorton & Arvind Krishnamurthy, "Risk Topography" (2011) 26 NBER Macroeconomics Annual 149 at 169.

\(^{17}\) IMF, BIS & FSB, *supra* note 15 at 2-3.

of failure, and that have many indirect linkages to other industries, are a greater source of systemic risk.

Promoting stability by monitoring and reducing systemic risk features prominently in the mandates of securities regulators worldwide. Indeed, the International Organization of Securities Commissions (IOSCO) has identified "reduc[ing] systemic risk" as one of three main objectives of securities regulators.19

Securities commissions in Canada are also committed to reducing systemic risk. Consider that the mission statement of the CSA explicitly states that a priority of the Canadian regulatory system must be to "reduce[] risks to market integrity."20 Former vice-chair of the Ontario Securities Commission (OSC), Mary Condon, addressed the importance of reducing systemic risk domestically in a 9 July 2012 speech to the Toronto Securities Leadership Seminar:

"Promoting financial stability has become a fundamental objective of securities regulators—it is critical for protecting the interests of investors and the integrity of our markets....[A]t the OSC, we are integrating systemic risk planning into our strategic planning and ongoing policy work. For example, supporting and promoting financial stability is a new organizational goal for the OSC."

Clearly, addressing contributing factors and sources of systemic risk is a priority for financial regulators in Canada and worldwide.

That the hedge fund industry, as a whole, contributes to systemic risk is settled. As will be explained, the techniques and interconnectedness of the industry make it capable of perpetuating and amplifying negative movements across the entire financial system.22

The techniques of the hedge fund industry are a mixed blessing. On the one hand, hedge funds are of benefit to the overall financial system, while on the other, they also create economic concerns. Gerber, Vance and Pasteur explain the tension caused by hedge funds:

Regulators, economists, and industry professionals all tend to agree that hedge funds can benefit the overall economy by mitigating significant

price downturns...[and] these benefits are attributed to the relaxed regulations requirements imposed on hedge funds. However, less regulation also creates significant economic concerns.23

More specifically, the benefits alluded to above include greater market efficiency, new market exposures not available through long position investing, more effective corporate governance, and enhanced market liquidity.24 However, these benefits come at a price: systemic risk.

The hedge fund industry techniques that contribute to systemic risk have been the subject of extensive commentary. Much of this commentary focuses on hedge fund leverage, or gearing.25 In simple terms, leverage involves borrowing funds to extend investment; then, overall gains are realized when the invested funds outperform the cost of the borrowed funds. In a practical sense, leverage is achieved through repurchase agreements, short positions and derivatives contracts, all of which are popular hedge fund techniques.26 The result of leverage is that gains and losses are amplified; hence risk is amplified. The danger on the downside is that "selling and risk-reducing behaviour can result in a vicious circle of selling begetting more selling, market panic and distressed sellers."27 Doyran explains why hedge fund industry techniques that lead to excessive leverage are a source of systemic risk:

Systemic risk from hedge funds can stem from two sources: 1) banks’ massive exposure to them as counter-parties, [and] 2) their potential to act contagiously on unrelated classes of assets and other financial institutions as they are forced to significantly de-leverage or unwind their positions during a crisis.28

The latter source, widespread financial instability caused by hedge funds relieving leverage, is of particular concern to regulators because, as mentioned above, it can quickly spiral into market panic. The former source, institutional exposure to hedge funds, is a function of the interconnectedness of the industry throughout the financial system.

It is important to acknowledge that the hedge fund industry is not alone or particularly unusual in its use of leverage. Other types of funds...
and financial market participants also rely on leverage. Hedge funds may even be considered modest in their use of leverage compared with other market intermediaries, such as investment banks. Ang, Gorovyy and van Inwegen explain with reference to the leverage ratios of several financial industries around the time of the global financial crisis:

As hedge fund leverage declines in 2007 and continues to fall over the financial crisis in 2008 and early 2009, the leverage of financial institutions continues to inexorably rise. The highest level of gross hedge fund leverage is 2.6 at June 2007, well before the worst periods of the financial crisis. In contrast, the leverage of investment banks is 10.4 at June 2007 and severely spikes upwards to reach a peak of 40.7 in February 2009.

That is to say, the use of leverage is not unique to the hedge fund industry, and does not implicate it as a financial culprit.

The interconnectedness of the hedge fund industry also contributes to systemic risk. The meteoric growth of the industry in the last decade is largely due to the institutionalization of hedge funds. Every investment bank and private equity firm has either started or acquired a fund, and "no self-respecting pension fund or university endowment has holdings not found in hedge fund investments." The hedge fund industry is directly and indirectly linked to many financial institutions and sectors. And while the interconnectedness of hedge funds is not in and of itself a source of systemic risk, it does magnify that which is already present. Doyran explains:

The size of the hedge fund industry is relatively small when compared to commercial banks, investment banks, mutual funds and pension funds. Although hedge funds should not be singled out for "causing" systemic risk, their impact can be greatly magnified by trading strategies and excessive leverage based on complex derivatives contracts and short-selling.

The interconnectedness of the hedge fund industry, then, contributes to systemic risk because its exposure throughout the financial system can magnify that risk which already exists.

30. Ibid at 26.
31. AIMA, Roadmap 2012, supra note 8 at 126.
32. Christofi et al, supra note 1 at 25.
33. Doyran, supra note 22 at 28.
Clearly, monitoring and reducing sources of systemic risk is a priority for financial regulators. It is equally evident that the hedge fund industry, by its use of leverage and its interconnectedness, contributes to systemic risk. And yet, until as recently as 2010 regulators did not, or could not, monitor the systemic risk contributed to by the industry. Instead, the hedge fund industry typically operated outside of the rigorous regulations that addressed other investment products.

Armed with robust new legislative authority, regulators worldwide are now prepared to address the elephant in the room. Indeed, the broad regulatory freedom afforded to the hedge fund industry in some important jurisdictions is being narrowed. Undoubtedly, the industry is entering a period of increased regulatory oversight and transparency.\(^\text{34}\) Much of this new hedge fund regulation is intended to enhance financial stability by monitoring and reducing systemic risk contributed to by the hedge fund industry.

3. Research purpose and paper overview

The purpose of this paper is to suggest a model by which Canadian securities regulators may monitor the systemic risk caused by the domestic hedge fund industry. The bases for this proposal are the recent regulatory reform initiatives undertaken in the U.S. and Europe. There, regulators have taken unprecedented steps to reduce systemic risk by implementing new hedge fund reporting and monitoring regimes. These mandatory reporting and monitoring regimes, labeled Form Private Fund (Form PF) in the U.S. and the Alternative Investment Fund Managers Directive (AIFMD) in Europe, are providing securities regulators with comprehensive insights into fund risk profiles.\(^\text{35}\) This paper asks: to what extent might the hedge fund reporting and monitoring regimes adopted in the U.S. and Europe be appropriate and practicable for the Canadian hedge fund industry? Or, more specifically, which features of Form PF and AIFMD are appropriate in the Canadian regulatory context?

Rather obviously, the hedge fund reporting and monitoring initiatives undertaken in the U.S. and Europe are not entirely appropriate for the Canadian regulatory environment. For one thing, those industries are considerably larger, in terms of capital invested (or AUM) and number of funds, than the Canadian industry. A simple cut-and-paste approach to regulatory reform in Canada is unsuitable. Therefore, a more selective

\(^{34}\) Mary Jo White, “Hedge Funds: A New Era of Transparency and Openness” (Speech delivered at the Managed Funds Association Outlook 2013 Conference, New York, 18 October 2013), online: SEC <www.sec.gov>.

\(^{35}\) Ibid.
means of assessing the appropriate features of Form PF and AIFMD is necessary.

Two criteria will be used to assess the appropriateness of the features of Form PF and AIFMD: average industry fund size, or AUM (the terms are hence used interchangeably), and the cost of compliance. As regards the former criterion, Form PF in particular is progressive; that is, larger funds report more information and more frequently than smaller funds. Only those features that are intended for smaller funds are appropriate in the Canadian context. As regards the latter criterion, recent industry research suggests that the cost of compliance is not uniform amongst industry participants; indeed, smaller participants are disproportionately burdened by reporting. Only features sensitive to the cost of compliance for smaller funds are appropriate in the Canadian context.

An important presumption driving this analysis is that a systemic risk reporting and monitoring regime is desirable, or at least beneficial, for the Canadian hedge fund industry. While it is clear that Canadian securities regulators are focused on reducing systemic risk, it is less clear that they are able to direct scarce resources towards the negligible risk caused or contributed to by Canadian hedge funds. As will be discussed, the Canadian industry is relatively small and fragmented, and the funds therein are already subject to regulation; it is reasonable to surmise that implementing a costly reporting regime is not a priority for Canadian regulators. However, for the sake of analysis, and with due sensitivity to the distinct Canadian context, an appropriate regime will be tabled.

The outline of this paper is a journey through global hedge fund regulation. The journey begins in the U.S., moves to Europe, and finally arrives in Canada. For each jurisdiction, the hedge fund industry and regulatory framework is introduced. Then, the features of the reporting regimes are identified. Finally, those features are assessed for their appropriateness in the Canadian context.

I. U.S. hedge fund industry and regulation reform

“We’re gonna need a bigger boat.”
—Roy Schnieder as Brody in *Jaws*

The U.S. hedge fund industry was unique in that it operated with maximum flexibility. More so than in other jurisdictions, U.S. hedge funds were

largely exempt from the disclosure and registration requirements intended to capture other private funds. Or more precisely, they were organized to benefit from numerous, deliberate exemptions in securities and corporate legislation.38 This amenable, rules-based regulatory framework attracted much interest from talented managers and investors alike. Not surprisingly, the U.S. hedge fund industry has grown substantially in the last two decades; recent estimates suggest that it accounts for 70 per cent of global hedge fund investment!39

This section discusses the U.S. hedge fund industry and existing regulatory framework, and hedge fund regulation reform in the U.S. and the features of Form PF.

1. Give me liberty...: The U.S. hedge fund industry and regulation primer

The U.S. hedge fund industry is mature, both in terms of composition and regulation. That is to say, the industry is large, stratified, and highly concentrated, and the existing regulatory framework was antiquated. This section briefly describes the composition of the U.S. hedge fund industry and outlines the existing regulatory framework.

The U.S. hedge fund industry has many large- and very large-sized funds, and is highly concentrated. According to industry data from 2012, "[a]round 61% of assets are concentrated in 3.7% of the hedge funds that have more than $1 billion under management."40 The global financial crisis did much to perpetuate this trend.41 With so much capital concentrated in relatively few large funds, the need for systemic risk monitoring is made more obvious.

In the U.S., hedge funds were typically structured and operated so as to benefit from exemptions to existing securities and corporate legislation. Of particular importance to this analysis are those exemptions pursuant to the Securities Act 193342 and the Investment Company Act 1940,43 as they allowed funds to avoid disclosing their holdings and risk exposure to the SEC.

39. AIMAl, Roadmap 2012, supra note 8 at 20.
40. Ibid at 19.
41. Ibid.
42. Pub L 73-22, 48 Stat 74 (1933).
43. Pub L 76-728 (1940).
The Securities Act 1933 requires entities that issue securities to provide full and fair disclosure.\textsuperscript{44} This disclosure includes information about fees, expenses, performance, and most importantly, holdings.\textsuperscript{45} If provided, this information could be utilized by investors and regulators alike to monitor risk exposure. However, according to Bianchi and Drew, "[h]edge funds circumvent this requirement via section 4(2) and regulation D of the Act, exempting funds that offer securities by private placement, which are securities that are not offered via public advertisement or appeal."\textsuperscript{46} Hedge funds also avoid the regulation D requirement (specifically Rule 506 of regulation D) by only offering investment to a limited number of high net worth individuals, defined in the legislation as "accredited investors."\textsuperscript{47}

The Investment Company Act 1940 imposes more onerous disclosure and reporting requirements than the Securities Act 1933. The Investment Company Act 1940 requires all companies that meet the statutory definition of "investment company" to "register with the [SEC] and disclose their investment positions and financial condition."\textsuperscript{48} From a systemic risk monitoring perspective, this information is invaluable. Here again, hedge funds avoid divulging their holdings and risk exposure by structuring themselves to avoid two key provisions (sections 3(c)(1) and 3(c)(7)). To do so, funds limit their number of beneficial owners to less than one hundred, and offer investment only to "qualified purchasers" (viz. those with greater than $5 million invested).\textsuperscript{49} Of note, the Dodd-Frank Act has largely superseded the Investment Company Act 1940.

It is clear that the U.S. regulatory framework was flexible enough for hedge funds to benefit from exclusions intended to oversee the financial markets and securities. Similarly, the U.S. legal environment was silent on the use of leverage and systemic risk management.\textsuperscript{50} All that would change following the global financial crisis: enter the Dodd-Frank Act and Form PF.

\textsuperscript{44} SEC, Implications of the Growth of Hedge Funds, supra note 38 at 13.
\textsuperscript{45} Christofi et al, supra note 1 at 30.
\textsuperscript{46} Bianchi & Drew, supra note 3 at 11.
\textsuperscript{47} SEC, Implications of the Growth of Hedge Funds, supra note 38 at 15.
\textsuperscript{48} Christofi et al, supra note 1 at 30.
\textsuperscript{49} SEC, Implications of the Growth of Hedge Funds, supra note 38 at 11-12.
\textsuperscript{50} Bianchi & Drew, supra note 3 at 11.
In response to the global financial crisis, the U.S. Congress passed the *Dodd-Frank Act* in July 2010. The Act, which represents the most extensive legislative overhaul of financial regulations since the 1930s, was intended to reduce systemic risk, increase transparency, and promote market integrity. As such, the *Dodd-Frank Act* affected all financial institutions and industries in the U.S.

Some are critical of the *Dodd-Frank Act*, suggesting that its massive scope is excessive and knee-jerk, even referring to it as "quack corporate governance regulation." Others point out that the Act does not adequately focus on the toxic securities at the centre of the global financial crisis. Such is typical of a so-called boom-bust-regulate pattern of regulation: regulation is hastily adopted during and immediately following a financial crisis, and is often driven by policy and political agenda rather than need. Indeed, the *Dodd-Frank Act* extends to institutions and industries with tangential or debatable links to the global financial crisis. This is certainly true of the hedge fund industry. There is considerable and ongoing debate about the extent to which the U.S. hedge fund industry contributed to the global financial crisis, if at all. However, this debate is outside the scope of this paper. The simple fact is that the *Dodd-Frank Act* does affect regulatory reform for the hedge fund industry, regardless of whether it should.

This section briefly describes the extent of hedge fund regulatory reform in the U.S. vis-à-vis systemic risk, and describes the function and features of Form PF.

Pursuant to Title IV of the *Dodd-Frank Act*, the SEC undertook to monitor the systemic risk caused or contributed to by the U.S. hedge fund industry.
industry. In particular, the Act directed the SEC to collect basic, non-public information from hedge funds and advisors regarding their risk profiles.\textsuperscript{56} According to the SEC:

Section 404 [of the \textit{Dodd-Frank Act}] directed the [SEC] to establish reporting requirements for investment advisers to private funds as necessary and appropriate in the public interest and for the protection of investors or for assessment of systemic risk by the Financial Stability Oversight Council (FSOC).\textsuperscript{57}

This broad mandate directed the SEC to collect information as never before, and to share that information with the FSOC. In particular, the \textit{Dodd-Frank Act} specified that reporting must include information about: “the amount of assets under management, use of leverage...and trading practices for each private fund managed by the adviser.”\textsuperscript{58}

On 31 October 2011, the SEC adopted Form PF as the mode of collecting systemic risk information from all private funds, including hedge funds.\textsuperscript{59} According to Norm Champ, deputy director, SEC Office of Compliance Inspections and Examinations, “[t]he information reported in Form PF will be used by the [FSOC] to monitor risks to the U.S. financial system and by the SEC to conduct risk assessments.”\textsuperscript{60} This approach of reporting and monitoring represents a paradigm shift in hedge fund regulation: “[u]sing this information, regulators can then assess trends over time and identify risks as they are emerging, rather than reacting to them after they unfold.”\textsuperscript{61}

The features of Form PF are intended to provide the SEC and FSOC with data about hedge funds that is practicable and adequately comprehensive. Above all, Form PF is progressive; that is, the depth and frequency of the filing depends on fund size.\textsuperscript{62} The four features of Form PF that are identifiable from the SEC \textit{Annual Staff Report Relating to the Use of Data Collected from Private Fund Systemic Risk Reports} are (a) a minimum size exemption, (b) progressive reporting frequencies, (c)

\begin{itemize}
  \item \textsuperscript{56} White,  \textit{supra} note 34.
  \item \textsuperscript{58} Ibid.
  \item \textsuperscript{59} Ibid.
  \item \textsuperscript{60} Norm Champ, “What SEC Registration Means for Hedge Fund Advisers” (Speech delivered to the New York City Bar, 11 May 2012), online: SEC <www.sec.gov>.
  \item \textsuperscript{61} White,  \textit{supra} note 34.
  \item \textsuperscript{62} Jeff Rhodenizer, “Form PF: Measure Twice, Cut Once” (2013) HFM Week Special Report: Cayman 2013, 35 at 35 [Rhodenizer, “Measure Twice, Cut Once”].
\end{itemize}
progressive depth of reporting, and (d) extensive data sharing. Each will be discussed separately.

a. Minimum size exemption
Funds with less than USD 150 million regulatory funds under management (RAUM) are exempt from reporting. RAUM was selected to measure fund size because it measures the gross assets of all securities in the fund portfolio before subtracting any leverage or other liabilities. According to Jeff Rhodenizer of Admiral Administration, "[t]he new method provides more consistency in the reporting of funds than the traditional [net asset value], where use of leverage may distort the potential impact of assets on the [U.S.] financial system." It is also worth noting that RAUM is measured at the advisor level, which means that single (institutional) advisors may not divide their managed AUM between multiple funds to avoid reporting. This exclusive feature of Form PF was added based on industry concerns about the disproportionately burdensome impact of reporting on very small funds.

b. Progressive reporting frequencies
The frequency of Form PF filing increases as fund RAUM increases; not surprisingly, the SEC and FSOC demand more frequent filings from larger, riskier hedge funds. Ostensibly, the progressivity of this feature is intended to capture the enhanced risk and interconnectedness of large and very large funds. Funds and advisors with between USD 150 million and 1.5 billion RAUM are required to file annually, and those with greater than USD 1.5 billion RAUM must file quarterly. Besides filing less frequently, small- and medium-sized funds also have more lenient filing deadlines. Funds and advisors with less than USD 1.5 billion RAUM have 120 days from the fiscal year end to file Form PF, while those with greater than USD 1.5 billion RAUM have just 60 days.

c. Progressive depth of reporting
Just as smaller funds are subject to less frequent reporting than larger ones, so too are smaller funds required to report less data than larger funds. Here again, the progressivity of this feature captures the enhanced risk and interconnectedness of large and very large funds. Conveniently, the

63. SEC, Annual Staff Report re Use of Data, supra note 57.
64. Rhodenizer, " Measure Twice, Cut Once," supra note 62 at 35.
65. Ibid.
66. SEC, Annual Staff Report re Use of Data, supra note 57 at 4-5.
67. Ibid at 4.
68. Ibid at 5.
progressivity of the data-reporting regime is based on the same RAUM threshold as the reporting frequency. Funds and advisors with between USD 150 million and 1.5 billion RAUM are required to report the following general data: types of funds advised or managed; fund metrics such as size, leverage, liquidity, and performance; types of investors; fund strategy; and use of trading and clearing mechanisms. This general information allows regulators to assess the likelihood that investors will withdraw their funds in a given period, and the impact of fund failure on counterparties. In addition to these general data, funds with greater than USD 1.5 billion RAUM must report more specific information, including: geographical concentration, turnover by asset class, risk profile, and direct and indirect forms of leverage and liquidity.

d. **Extensive data sharing**
The industry data collected by the SEC in Form PF are significant to many regulatory stakeholders. Besides the FSOC, the SEC shares the public and proprietary data it collects with other commissions and offices. The SEC lists several like-minded regulators that are making use of the Form PF data:

In particular, the Division of Economic and Risk Analysis has successfully incorporated Form PF data into its proprietary analytic tool; the Division of Investment Management’s Risk and Examinations Office is working to develop analytics using Form PF information that will allow it to monitor the risk-taking activities of investment advisers to private funds; and the Office of Compliance Inspections and Examinations anticipates using the information collected on Form PF in conducting pre-examination due diligence and in risk identification.

The SEC also provides non-proprietary data to IOSCO “so IOSCO has a more complete overview of the global hedge fund market for a report that will be shared with the Financial Stability Board.”

Not surprisingly, implementing Form PF reporting at the fund level is an immense challenge. Many funds and fund administrators are not tooled to collect the data required by the new regulation. Since implementing Form PF in 2012, advisors and administrators have been busy identifying

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69. Ibid at 4.
70. Interview of Jeff Rhodenizer (26 March 2014).
71. SEC, *Annual Staff Report re Use of Data*, supra note 57 at 4.
72. Ibid at 1.
73. Ibid.
data gaps and fielding data collection resources of their own.\textsuperscript{74} This is a costly process.

II. \textit{European hedge fund industry and regulation reform}

"Unity in diversity"

—European Union motto

Unlike the U.S. hedge fund industry, the European industry is multitudinous. That is, the European hedge fund industry is the aggregate of many national-level industries. Not surprisingly, regulation varied greatly amongst jurisdictions, and attempts at macro-level regulation have been a source of debate. Indeed, existing differences in national economies and legislation made harmonization particularly difficult.\textsuperscript{75} However, since the global financial crisis, powerful political and economic forces have largely overcome those differences and forced convergence on common European hedge fund rules.

This section discusses the European hedge fund industry, its existing regulatory framework, hedge fund regulation reform in Europe, and the features of AIFMD.

1. \textit{Achtung, hedgefonds!}: The European hedge fund industry and regulation primer

Prior to the global financial crisis, the European hedge fund industry was dominated by two opposing regulatory doctrines: one in favour of uniform regulation and one opposed to it.\textsuperscript{76} As regards the former doctrine, Germany and France advocated "a tougher regulatory regime for hedge funds and wanted the funds to be overseen similarly to banks."\textsuperscript{77} This more stringent approach was based on a deep mistrust of hedge fund practices and activities. Quaglia explains:

Policy-makers in France, Germany and Italy were keen to regulate hedge funds in the EU because they worried about activist investors, such as hedge funds and private equities, threatening to overturn 'cosy corporatism' in their domestic economies, disrupting established corporate governance arrangements.\textsuperscript{78}

By contrast, securities regulators in the U.K. advanced a "soft-hand" approach. Their regime favoured disclosure and transparency over direct

\textsuperscript{74} Rhodenizer, "Measure Twice, Cut Once," \textit{supra} note 62 at 36.
\textsuperscript{75} Quaglia, \textit{supra} note 4 at 666.
\textsuperscript{76} \textit{Ibid} at 670.
\textsuperscript{77} \textit{Ibid}.
\textsuperscript{78} \textit{Ibid} at 674 [citation omitted].
regulation. There, the Financial Services Authority (FSA), now the Financial Conduit Authority and the Prudential Regulation Authority, committed to curtail additional regulation unless market failure required otherwise.\textsuperscript{79} The opening statement of a 2006 FSA discussion paper, entitled \textit{Hedge Funds: A Discussion of Risk and Regulatory Engagement}, provides a rationale for the relatively light regulation:

\begin{quote}
We recognise the growing importance of hedge funds and their contribution to financial markets. The number of managers is growing and London is a major centre of hedge fund manager activity (second only to New York for location of managers). We are committed to playing our part to ensure the U.K. remains an attractive location for hedge fund managers to be based.\textsuperscript{80}
\end{quote}

Not unlike the U.S. industry at the same time, the favourable regulatory environment in the U.K. had attracted talented managers and much investment; the industry was booming. However, following the global financial crisis, this doctrine of “soft-hand” regulation was conceded, paving the way for a more comprehensive regulatory architecture.\textsuperscript{81} Enter AIFMD.

2. \textit{European hedge fund regulation reform and AIFMD}

“The Alternative Investment Fund Managers Directive (AIFMD), the most significant piece of regulation to be introduced to the alternatives industry, has been met by the European financial community with a degree of confusion and concern.”

—Mario Mantrisi, KNEIP\textsuperscript{82}

With the backing of Germany and France, the European Commission set out in 2009 to reform the alternative investment industry in Europe. This was seen as an important part of the Commission’s overall response to the global financial crisis. Indeed, alternative investments, including hedge funds, were singled out for more stringent regulation because, according to the Commission, “recent events have demonstrated that the activities of [alternative investments] are not sufficiently transparent and that the associated risks are not sufficiently addressed by current regulatory and

\begin{thebibliography}{99}
\bibitem{Sami} George Sami, “A Comparative Analysis of Hedge Fund Regulation in the United States and Europe” (2009) 29:1 Nw J Intl L & Bus 275 at 300.
\bibitem{Quaglia} Quaglia, supra note 4 at 671.
\end{thebibliography}
supervisory arrangements. The stated purpose of the AIFMD proposal was fourfold: to harmonize regulatory standards on an ongoing basis, to enhance transparency towards investors and public authorities, to enable member states to improve macro-prudential oversight, and to overcome gaps and inconsistencies in the existing regulatory framework.

On 11 November 2010 the European Parliament voted overwhelmingly to adopt AIFMD. Speaking on the occasion, José Manuel Barroso, former President of the European Commission, commented:

The adoption of the directive means that hedge funds and private equity will no longer operate in a regulatory void outside the scope of supervisors. The new regime brings transparency and security to the way these funds are managed and operate, which adds to the overall stability of our financial system.

Alternative investments, including hedge funds, were hence subject to transnational European regulation that included “reporting requirements of systemically important data to supervisors.” Pursuant to Article 47 of Directive 2011/61/EU, implementation and collection of AIFMD data was delegated to the European Securities and Markets Agency (ESMA) and the European Systemic Risk Board.

According to the ESMA, the features of AIFMD are intended to provide more comprehensive and consistent data on hedge fund and private equity fund activities. Foremost, AIFMD stresses uniformity as the appropriate approach to data collection; the principles guiding ESMA in collecting data are that there be “common, uniform and consistent application of the reporting obligations.” In that sense, AIFMD is inherently less progressive than Form PF. The three features of AIFMD

84. Ibid.
86. Ibid.
87. Quaglia, supra note 4 at 673.
88. Ibid.
91. EC, European Securities and Markets Authority, Final Report: Guidelines On Reporting Obligations Under Articles 3(3)(d) and 24(1), (2) and (4) of the AIFMD (Paris: ESMA, 2013) [ESMA, Guidelines On Reporting Obligations].
that are identifiable from the ESMA guidelines on data reporting, entitled *Final Report: Guidelines on Reporting Obligations under Articles 3(3)(d) and 24(1), (2) and (4) of the AIFMD*, are: (a) a minimum size exemption, (b) progressive reporting frequency, and (c) uniform depth of reporting.  

Each will be discussed separately.

a. **Minimum size exemption**

Funds with less than €100 million AUM are exempt from reporting. Additionally, AIFMD discriminates in favour of funds that do not use leverage: "[a] higher threshold of 500 million applies to AIFM not using leverage (and having a five years lock-in period for their investors) as they are not regarded as posing systemic risks." To put this exemption in perspective, the ESMA estimates that it will only apply to funds with ten per cent of total industry AUM.

b. **Progressive reporting frequency**

The reporting frequency of AIFMD data depends on the size and activities of the fund. Depending on the fund AUM and whether it uses leverage as strategy, reporting may be annually, semi-annually, or quarterly. For funds that exceed the minimum size threshold and are unlevered, reports must be filed annually. For funds that are levered, those with less than €1 billion must file semi-annually and those with greater than €1 billion must file quarterly. As with Form PF, this feature is intended to capture the enhanced risk and interconnectedness of large and very large funds.

c. **Uniform depth of reporting**

The quantity and quality of data that all fund managers must report under AIFMD are substantial. In total, managers must report 130 data points for each fund they manage; "[t]his could mean that larger [managers] will be required to capture thousands of points of data from multiple funds and from many different sources." According to the ESMA, there are two broad categories of required AIFMD data: portfolio concentration and risk profile. Portfolio concentration data include breakdown of investment strategies, principal markets, fund AUM, and principal exposures. Risk profile data include fund risk measures, liquidity profile, and fund leverage

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91. Ibid.  
92. EC, "Commission proposes EU framework," supra note 83.  
93. Ibid.  
94. ESMA, *Guidelines on Reporting Obligations*, supra note 90 at 46.  
95. Mantrisi, supra note 82 at 57.  
96. ESMA, "ESMA clarifies reporting requirements," supra note 89.
(where applicable). Together, these two categories of AIFMD data constitute a substantial burden on European-domiciled hedge funds.

As with Form PF, AIFMD reporting has created a host of costly organizational requirements. However, funds themselves may stand to benefit from the new reporting regime:

The road to AIFMD compliance must start with organizations taking stock of their entire fund strategy....Those that take this opportunity to “clean house” will not only reduce their compliance burden, they will also streamline their operations and fine-tune their strategies.97

III. Canadian hedge fund industry and regulation

“Canada has often been described as the emerging market play without the emerging market risk—we find ourselves, fortunately, at the intersection of global interests with a strong commodities sector and robust financial architecture on offer.”

—Claude Robillard, CIBC Prime Services Group98

As the leading quotation suggests, Canada has a desirable, albeit relatively small, hedge fund industry. A stable financial sector, effective regulation, and increased institutional-investor confidence are but a few factors that have contributed to growth in the industry. According to Gary Ostoich, President of the Canadian chapter of the Alternative Investment Management Association, “[t]his has resulted in a dramatic shift and growth in the AUM of the industry, which is estimated to have grown from $12 billion five years ago to over $30 billion today.”99 This remarkable growth occurred despite a record number of Canadian-domiciled hedge funds closing in the last twelve months.100 The Canadian hedge fund industry is, after all, not immune to the powerful forces that offset growth in other sectors and jurisdictions.

This section briefly describes the Canadian hedge fund industry and the existing regulatory framework.

100. Ibid.
1. The Canadian hedge fund industry and regulation primer

"From a regulatory perspective, Canada has had a comprehensive framework for money managers, including hedge funds, for decades."

—Gary Ostoich, President AIMA Canada

In true Canadian fashion, the domestic hedge fund industry is sensible and modest. This is not to say that the Canadian industry is insignificant. Rather, it is simply less mature and far less extravagant than its much larger cousin to the south.

The Canadian industry is relatively small, both in terms of total investment and average fund size. First, consider that the CAD 30 billion or so invested in the Canadian hedge fund industry amounts to a little more than one per cent of the USD 2.63 trillion invested in hedge funds globally. Second, consider that the Canadian space is populated by roughly 250 individual funds, most of which have between $50 million and $100 million AUM. Indeed, only 15 per cent of Canadian funds manage more than CAD 100 million. Compare those figures with the U.S. hedge fund industry, where there are more than four thousand funds with greater than USD 1.5 billion RAUM. Based on the foregoing figures, the majority of Canadian hedge funds would not meet the minimum size exemptions for Form PF or AIFMD.

However, some see the small size of the Canadian industry not as a deterrent, but as an opportunity. For many domestic and international investors, the Canadian hedge fund industry is an attractive alternative to the saturated U.S. industry, where massive size has tended to limit arbitrage opportunities. In some respects, the small size of many Canadian funds allows them to be more innovative. Katrina Rempel of BMO Capital Markets Prime Brokerage Services explains: "[t]he smaller size of many Canadian funds enables the managers to be nimble and quickly capitalize on opportunities in the market that might elude larger funds." The Canadian hedge fund industry may be small, but it is mighty.

101. Ibid.
103. Robillard, supra note 98 at 54.
104. Ibid.
105. SEC, Annual Staff Report re Use of Data, supra note 57 at 5.
106. Robillard, supra note 98 at 55.
With the foregoing in mind, it is important to acknowledge that the Canadian hedge fund industry does not contribute appreciably to systemic risk. Indeed, it is not clear whether the Canadian industry contributes to systemic risk at all. Based on our understanding of the nature of systemic risk, industries that are small (in terms of number of participants or volume of transactions) and fragmented, such as the Canadian hedge fund industry, contribute relatively little to systemic risk. Further, Canadian hedge funds tend to use leverage sparingly (most with gearing ratios of less than 2:1), and some do not use leverage at all. However, this does not necessarily obviate the need for a domestic hedge fund reporting and monitoring regime. If the Canadian hedge fund industry continues on its current growth trajectory, then it may in the future contribute meaningfully to systemic risk. Again, an important presumption of this paper is that a systemic risk reporting and monitoring regime is desirable or beneficial for the Canadian hedge fund industry.

The regulatory framework within which Canadian hedge funds operate is familiar. In fact, it is the same regulatory framework with which all other securities market participants must comply. Foremost, securities regulation in Canada is a matter of provincial jurisdiction; however, for practical purposes, most securities regulations are harmonized as CSA National Instruments such that compliance is effectively consistent. Broadly speaking, the regulations that apply to hedge funds may be classified as either registration or disclosure requirements.

Of particular importance to Canadian hedge funds and those that manage them are the registration regulations set out in National Instrument 31-103 Registration Requirements, Exemptions and Ongoing Registrant Obligations. Condon, Anand and Sarra explain the significance of that National Instrument:

In fall 2009, a major harmonization effort was accomplished in the registration area with the introduction of NI 31-103, Registration Requirements and Exemptions, which recast [the] categories of registration, streamlined substantive registration requirements, and clarified the role of self-regulatory organizations in this area.

110. Registration Requirements, Exemptions and Ongoing Registrant Obligations, OSC, NI 31-103, (2013) OSCB 5723 (6 June 2013) [NI 31-103].
According to NI 31-103, those in the "business" of trading, such as hedge fund managers, must register as Dealers (section 7.1(1)), Advisers (section 7.2(1)), or Investment Fund Managers (section 7.3). Hedge fund managers typically avoid Dealer status by registering as Exempt Market Dealers pursuant to section 7.1(1)(d) of NI 31-103, but are subject to the Advisor and Investment Fund Managers requirements.

As regards disclosure regulation, most hedge funds avoid the detailed prospectus requirements by relying on exemptions set out in NI 31-103 and National Instrument 45-106 Prospectus and Registration Exemptions. In particular, funds can avoid issuing a prospectus under NI 45-106 by offering only to "accredited investors," which includes Schedule III banks (s. 1.1(a)), individuals with greater than $1 million financial assets (section 1.1(j)), or individuals with gross annual income greater than $200,000 (section 1.1(k)). Condon, Anand and Sarra explain the rationale for such a disclosure exemption:

The policy rationale for waiving prospectus requirements where the purchaser of securities meets a certain threshold of wealth or investment sophistication is...that financings can thereby be conducted on more efficient terms without unduly compromising investor protection.

To be sure, that hedge funds and those that manage them rely on statutory exemptions to avoid certain registration or disclosure requirements is not a fault of the regulatory system. These exclusions are deliberate and intended to enhance market efficiency while maintaining investor protection. As such, this description is not intended to suggest that the exemptions used by Canadian hedge funds, or those in other jurisdictions for that matter, are unnecessary or ill conceived.

In addition to NI 31-103 and NI 45-106, domestic hedge funds and those that manage them must be aware of certain additional rules set out in Ontario's Securities Act and Regulations. This legislation is significant because many Canadian funds are domiciled in that province. However, for the purpose of this analysis, the regulations and exemptions set out in the National Instruments are an ample demonstration of the Canadian hedge fund framework.

112. NI 31-103, supra note 110, s 7.
113. Renton, supra note 109 at 29.
117. Cathy Singer, Barry Segal & Michael Bunn, "Foreign Investors in Canadian Hedge Funds" in AIIMA Canada, Handbook, supra note 98, 58 at 58.
Clearly, the Canadian hedge fund regulatory framework is extensive. Indeed, some industry commentators have described it as being “[s]ome of the world’s most comprehensive regulation.”118 And yet there is no system in place for reporting and monitoring the systemic risk contributed to by the Canadian hedge fund industry.

IV. Proposed Canadian systemic risk reporting regime

Having described the hedge fund industries and corresponding regulations in the U.S., Europe and Canada, and having identified the features of Form PF and AIFMD, it is now possible to answer the question posed at the outset. Again, that question is which features of Form PF and AIFMD are appropriate for the Canadian regulatory context? To answer that question, each of the five discrete features identified in the discussion above will be qualitatively assessed using one or both of the criteria described below. The result will be a set of features appropriate for a Canadian systemic risk reporting regime.

This section discusses the two qualitative criteria used to assess the Form PF and AIFMD features, which of those features are appropriate in the Canadian regulatory context, and which regulatory body would likely implement and operate a Canadian systemic risk reporting regime.

1. A tale of two criteria

“Mo’ Money, Mo’ Problems”

—Christopher Wallace, The Notorious B.I.G.

The two criteria by which the features of Form PF and AIFMD are to be assessed are average industry fund size and cost of compliance. These two criteria were selected to assess the features of Form PF and AIFMD because they are mostly independent of the unique regulatory frameworks. Each criterion will be described separately.

The average industry fund size criterion is simply a rough-order-of-magnitude characterization of the composition of fund sizes that make up the particular hedge fund industry. The rationale being that reporting features designed to capture data from large funds may not be appropriate for industries with small funds, and vice versa. In doing so, it is not necessary to calculate a precise AUM or to define precise classification thresholds; for this qualitative analysis, simply characterizing the funds of an industry as small, medium, large and very large will suffice. For

example, it is sufficient to say that Canadian hedge funds are, on average, small, and that U.S. funds are, on average, medium to very large.

The cost of compliance criterion is based on recent industry research conducted by KPMG International. In 2013, KPMG International, the Alternative Investment Management Association, and the Managed Funds Association released a comprehensive study of the global impact of regulatory compliance on hedge funds. That study, entitled “The Cost of Compliance: 2013 KPMG/AIMA/MFA Global Hedge Fund Survey,” is intended to “provide...managers and regulators with valuable data to help inform and drive their decision making processes and add...to the existing body of knowledge on the cost of regulatory compliance for the hedge fund sector.” In doing so, the researchers surveyed and interviewed 200 fund managers worldwide with a combined AUM of USD 910 billion. Several finding of the KPMG research are particularly important to this analysis.

Foremost, the cost of regulatory compliance is substantial. According to “The Cost of Compliance,” “the [hedge fund] industry is investing heavily in compliance on average spending more than 7 percent of their total operating costs on compliance technology, headcount or strategy.” This amounts to more than USD 3 billion globally. Perhaps not surprisingly, the burden of all this compliance activity is disproportionately high for smaller hedge funds.

The relative cost of complying with the reporting regimes is greater for small funds than for larger funds. For small funds (those with less than USD 1 billion AUM), the average amount spent on compliance is USD 700,000. For medium and large funds (those with between USD 1 and 5 billion AUM and those with greater than USD 5 billion AUM respectively) the average amounts increase to USD 6 million and 14 million respectively. Expressed as a percentage of aggregated AUM, those figures amount to 0.24 per cent for small funds, 0.23 per cent for medium funds, and 0.09 per cent for large funds. In fact, small funds in the U.S. tend to spend upwards of 0.4 per cent of aggregated AUM on compliance. As far as reporting regimes such as Form PF and AIFMD are concerned, mo’ money does not necessarily mean mo’ problems.

120. Ibid at Foreword.
121. Ibid at 4.
122. Ibid.
123. Ibid at 15.
124. Ibid.
Based on the foregoing figures, it is clear that "[s]maller hedge funds seem to be spending more, both as a percentage of AUM and relative to operating costs, than their larger counterparts suggesting that some of the smaller funds may struggle in the face of increased regulatory scrutiny."125 The industry researchers reported on a further related figure that is of particular importance to this analysis:

Significantly, smaller hedge funds seem to be spending more on regulatory compliance costs on a relative basis than their larger counterparts. More than a third (35 percent) of hedge funds with less than USD250 million in AUM said compliance requirements represented more than 10 percent or more of their total operating costs.126

Given that most Canadian hedge funds are smaller than USD 250 million, a Canadian reporting regime would likely impose a similar burden.

The researchers also explored the differences, both in terms of time and costs, between compliance with Form PF and AIFMD. They found that the cost of complying with AIFMD is greater than that of Form PF. According to the researchers: "[i]n particular, respondents noted the high costs of AIFMD authorization and reporting....SEC registration and reporting was identified as the second most costly regulatory requirement to comply with."127 To put this in perspective, survey respondents ranked both Form PF and AIFMD compliance as being more demanding that FATCA compliance.128 According to "The Cost of Compliance," AIFMD is a particularly costly reporting regime because of the complexity associated with incorporating many regulatory jurisdictions.

2. Assessing the features of Form PF and AIFMD

"We [conclude] that our regime contains an appropriate securities regulatory framework for hedge funds, but that certain areas within it could be improved."

—CSA Staff Notice 81-316129

The Canadian hedge fund industry is unlike the U.S. and European industries in many ways. Perhaps most evident is the relatively small size of the Canadian industry; again, it accounts for a little more than one percent of global hedge fund investment, and Canadian funds typically have between CAD 50 and 100 million AUM. The size difference alone makes

125. Ibid at 5.
126. Ibid at 6.
127. Ibid at 10.
128. Ibid at 11.
129. CSA Staff Notice 81-316, Hedge Funds, supra note 11 at 277.
it difficult to select the appropriate features of Form PF and AIFMD for the Canadian industry.

Between the Form PF and AIFMD reporting regimes, there are five possible features for a Canadian systemic risk reporting regime: (a) a minimum size exemption, (b) progressive reporting frequencies, (c) progressive depth of reporting, (d) uniform depth of reporting, and (e) extensive data sharing. The appropriateness of these features will be assessed separately.

a. Minimum size exemption

Both the average industry fund size and cost of compliance criteria support a minimum size exemption for a Canadian systemic risk reporting regime. First, despite the Canadian industry comprising relatively small funds, there is a subset therein that is small enough not to contribute to systemic risk. As is the case with Form PF and AIFMD, it does not make sense to include those inconsequential funds in a systemic risk reporting regime. Second, from a cost perspective, requiring the smallest funds to report a comprehensive data set would be disproportionately burdensome. In fact, some suggest that doing so would act as a barrier to entry for new small funds. Therefore, a minimum size exemption should be included in a Canadian systemic risk reporting regime. But what AUM threshold should be adopted and how should that threshold be calculated?

The depth of this analysis does not permit a specific size exemption to be suggested. To do so would be purely speculative. However, any minimum size exemption for the Canadian hedge fund industry would surely be less than those of Form PF or AIFMD (USD 150 million and €100 million respectively). A more comprehensive assessment of Canadian hedge fund risk profiles and their counterparty relationships must be completed prior to determining a specific minimum size exemption.

A minimum size exemption should be calculated similarly to the Form PF exemption. That is, it should be based on fund RAUM, which is the gross assets of all securities in the fund portfolio before subtracting any leverage or liability. Again, this calculation provides a more consistent and meaningful measure of fund size than does straight AUM, which may distort the impact of the fund assets.

b. Progressive reporting frequency

The average industry fund size and cost of compliance criteria do not support a reporting regime that includes progressive reporting frequency. First, the Canadian industry is populated by small funds; most Canadian

130. Ibid.
funds have AUM between CAD 50 and 100 million, and few are larger than that. By contrast, in the U.S., 66 per cent of funds have between USD 150 million and 1.5 billion RAUM, and 34 per cent of funds have greater than USD 1.5 billion AUM.\(^{131}\) It is this subset of very large funds in the U.S. industry that justifies the progressive reporting frequency; the same subset does not exist in the Canadian industry. Without a subset of large and very large funds that contribute more to systemic risk, it is difficult to justify progressive reporting frequency for the Canadian hedge fund industry.

Second, the cost of reporting more than annually would be restrictively burdensome for most Canadian funds. As described in "The Cost of Compliance," the burden on small funds to comply with Form PF and AIFMD is substantial. Therefore, to suggest that small Canadian funds could report more than annually is not realistic.

c. Progressive depth of reporting
The average industry fund size criterion does not support a reporting regime that includes progressive depth of reporting. Here again, the Canadian industry is populated by mostly small funds. The U.S. reporting regime that supports this feature has many very large funds that can and should provide fuller data to the SEC. Some 34 per cent of funds in the U.S. industry have greater than USD 1.5 billion AUM; those funds cause and contribute to systemic risk more readily than do small- and medium-sized funds.\(^{132}\) Without a subset of large and very large funds that contribute more to systemic risk it is difficult to justify progressive reporting depth for the Canadian hedge fund industry.

d. Uniform depth of reporting
The average industry fund size criterion supports a reporting regime that collects uniform data from all qualifying hedge funds. The AIFMD regime requires all funds to report the same 130 data points; these data are intended to capture data from funds of all sizes. Indeed, a fund with little more than the minimum size exemption must report the same data as a very large European fund. A Canadian risk reporting regime should be tailored to the average industry fund size: small funds. An appropriate basis for the Canadian approach is the general data gathered from small and medium funds by Form PF, including: types of funds advised or managed; fund metrics such as size, leverage, liquidity, and performance; types of investors; fund strategy; counterparty credit risk; and, use of trading

\(^{131}\) SEC, Annual Staff Report re Use of Data, supra note 57 at 5.
\(^{132}\) Ibid.
and clearing mechanisms. These general data would allow a Canadian regulator to assess the likelihood that investors will withdraw their funds in a given period, and the impact of fund failure on counterparties.

e. **Extensive data sharing**
The two criteria are not necessary to evaluate the appropriateness of sharing systemic risk data; the appropriateness of this feature makes logical sense. A Canadian regulator charged with collecting data on systemic risk should share that information with any and all like-minded regulators. Doing so will give regulators a better understanding of the industry and enhance the regulatory goal of promoting financial stability. As with the Form PF data collected by the SEC, a Canadian regulator should also share non-proprietary data with international regulators, including IOSCO, so as to build a more complete picture of global systemic risk.

Based on the foregoing discussion, three Form PF and AIFMD features are appropriate in the Canadian regulatory context: (a) a minimum size exemption, (b) uniform depth of reporting, and (c) extensive data sharing. These three features are appropriate in the Canadian regulatory context because they are sensitive to the relatively small size of Canadian funds. They would also curtail the cost of complying with a new reporting scheme, a strain that is disproportionately burdensome for small funds.

3. **Whose line is it anyway?**

   "By analogy with Statistics Canada, it might be argued that broad national data-collecting powers may serve the national interest in a way that finds no counterpart on the provincial plane."

   ---Supreme Court of Canada, *Reference re Securities Act* 33

In 2011, the Governor in Council submitted a reference to the Supreme Court of Canada concerning the constitutional validity of a draft federal *Securities Act*. That draft legislation was an attempt by the federal government to consolidate provincial securities legislation into a single, national Act. In light of the constitutionally defined division of legislative power, the federal government asserted that "the securities market has evolved from a provincial matter to a national matter affecting the country as a whole and that, as a consequence, the federal general trade and commerce power gives Parliament legislative authority over all aspects of securities regulation." 34 The draft *Securities Act* suggested a single regulatory scheme to govern all aspects of the Canadian securities

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market(s); to implement this would supplant or marginalize the existing provincial regulatory power.

The Court responded to the reference question in the negative; as drafted, the national *Securities Act* was mostly unconstitutional. In reaching this decision, the Court acknowledged that systemic risk permeates provincial boundaries. According to the Court, the risk characteristics of investors in one provincial market can directly impact the characteristics of those in another. This recognition is important because it recognizes the possibility of a nationwide risk control and data collection mechanism. Indeed, the Court suggested just that at paragraphs 117 and 130:

Aspects of the Act, for example those aimed at management of systemic risk and at national data collection, appear to be directly related to the larger national goals which the Act proclaims are its *raison d'etre*.\(^\text{135}\)

[A] cooperative approach that permits a scheme that recognizes the essentially provincial nature of securities regulation while allowing Parliament to deal with genuinely national concerns remains available.\(^\text{136}\)

Given that monitoring systemic risk falls within the federal constitutional jurisdiction, a national regulator would likely implement and operate any Canadian systemic risk reporting regime.

Unilateral implementation of any such a regime is unlikely; as the Court wrote at paragraph 130 above, cooperation is the preferred mechanism for any systemic risk reporting and monitoring regime. Laskin and Patterson explain:

It is well established that both Parliament and provincial legislatures may delegate powers to agencies established by the other....[I]n the securities regulation context, the preferred delegation (assuming the objective is a single, national regulator) would be delegation "up" from the provinces to a federal agency.\(^\text{137}\)

Based on the Supreme Court of Canada’s decision in *Reference re Securities Act*, a national regulator should implement and operate a systemic risk reporting mechanism. However, such a regime would and should include the cooperation and inputs of provincial securities regulators. Indeed, their closeness to the Canadian hedge fund industry makes them ideally suited to the task of collecting systemic risk data through existing disclosure

\(^{135}\) Ibid at para 117.

\(^{136}\) Ibid at para 130.

channels. Such an approach would, according to the Court, respect the “growing practice of resolving the complex governance problems that arise in federations...by seeking cooperative solutions that meet the needs of the country as a whole as well as its constituent parts.”138

Conclusion
Monitoring and reducing systemic risk is a priority for financial regulators worldwide. Since the global financial crisis, securities regulators in the U.S. and Europe have taken steps to monitor the systemic risk caused or contributed to by the hedge fund industry. That industry in particular was singled out for more stringent regulation because of its interconnectedness and tendency to magnify existing systemic risk. The mechanisms adopted to collect hedge fund risk information in the U.S. and Europe are labeled Form PF and AIFMD respectively. Despite the risks posed by hedge funds, Canadian securities regulators have not taken similar steps to monitor the domestic industry.

This paper suggests a model, based on Form PF and AIFMD, by which Canadian securities regulators may monitor the systemic risk contributed to by the domestic hedge fund industry. In doing so, two qualitative criteria were used to identify the features of Form PF and AIFMD that are appropriate in the Canadian regulatory context: average industry fund size and cost of compliance. These criteria account for the relative size difference between the U.S. and European industries, and the Canadian industry.

Three features of Form PF and AIFMD were identified as being appropriate in the Canadian regulatory context: (a) a minimum size exemption, (b) uniform depth of reporting, and (c) extensive data sharing. First, a minimum size exemption recognizes that the smallest funds in the Canadian industry do not contribute appreciably to systemic risk; they should not be burdened with costly reporting. Second, uniform reporting recognizes that the average Canadian fund size is small. A tiered or progressive approach, like that of Form PF, is not justifiable where the industry does not contain many large- and very large-sized funds. Third, data sharing is desirable because it enhances the regulatory goal of promoting financial stability.

Finally, the Supreme Court of Canada suggested in Reference re Securities Act that a national regulator should implement and operate any Canadian systemic risk reporting regime. However, the Court also opined

that the preferred mechanism for any such regime would be cooperative and include the input of provincial regulators.

There can be little doubt that implementing a systemic risk reporting regime for the Canadian hedge fund industry would be a contentious undertaking. Such is the nature of financial regulation. In pursuing such a regime, Canadian securities regulators would surely encounter the delicate balance between protecting vulnerable investors, promoting innovation, and facilitating market efficiency. And as if that balance is not difficult enough, add yet another factor: keeping pace with regulatory initiatives in other jurisdictions—or, less formally, keeping up with the Joneses.