



Self-Regulatory Organizations in the Canadian Securities Industry



NATIONAL  POST

Keep little guys out of hedge funds

Retail investors better off in balanced funds

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Thursday, March 03, 2005

The Portus hedge fund debacle should motivate regulators to take another look at the accredited investor rules governing complex investments.

In theory, two rules were in place to limit how much access ordinary retail investors had to certain risky investments.

For years, the "sophisticated investor" rules required a minimum investment of \$97,000 to \$150,000 (depending on the province) in investments sold with an offering memorandum.

We'll focus on Ontario, where most Portus investors live. On Nov. 30, 2001, the Ontario Securities Commission approved Rule 45-501, which preserved the \$150,000 exemption and created a new exemption for "accredited investors."

The new rules stipulated that to be considered "accredited" an investor had to have \$200,000 taxable income in the previous two years. Couples had to have \$300,000 in annual household income or \$1-million in investable assets (excluding the value of a principal residence.) Similar rules are in place in British Columbia and Alberta.

Once deemed "accredited," these investors could invest as little as \$10,000 to \$25,000 instead of the previous \$150,000, which only the well-heeled could afford. (The actual minimum was set by managers.)

Professional advisors, financial planners and stock brokers are automatically considered accredited investors for their own accounts, says Stephen Kangas, managing director of Blumont Capital.

However, the new rule didn't cancel the previous "sophisticated investor" one.

So how was it small investors piled into complex products like Portus, with an average ticket of just \$30,000?

The industry got around the accredited investor rules by linking the underlying hedge funds to principal-protected notes (PPNs). Whether linked to hedge funds or regular equity mutual funds, PPNs can be sold with minimums as low as \$2,000, even to those who are neither affluent nor sophisticated.

The raison d'etre for PPNs was getting around those rules, says fund analyst Dan Hallett. But the Portus BankNote Trust was not even a note: it was a trust. Therefore the Portus products were neither regulated nor approved by any regulator.

One result of the hubbub is other hedge firms are increasing the level of disclosure for their products. An example is Blumont Capital, which has just posted revealing new explanatory information at its Web site at www.blumontcapital.com.

The fallout has caused investors to ask three basic questions, Blumont says:

- 1.) Is my money guaranteed?
- 2.) Who is managing my money?
- 3.) Do I have a separate account at Blumont Capital Corporation?

Blumont says its notes are issued and guaranteed by Citibank Canada and are "direct, unconditional obligations and deposits of Citibank."

The money is managed by Man Investments Ltd. and BluMont does not offer the PPNs through individual separately managed accounts. Blumont "does not exercise any discretion over the assets."

Blumont also posted a letter from Citibank saying each note is "guaranteed as to Principal repayment on the Maturity Date by Citibank Canada."

Calming words. Even so, "I don't think retail investors should buy hedge funds," says David Bruce, associate director with ScotiaMcLeod, "A low-cost balanced fund is the only hedge fund you need."