Canadian fund service providers expand at home and abroad

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Canada's hedge funds may be growing at a sluggish pace - the number of funds and their total assets grew by only some 5 to 7 per cent over the past year, according to industry tracker Canadian Hedge Watch - but the companies that service them are expanding rapidly as competition intensifies among established fund service providers, the country's banks and the Canadian arms of international financial services groups.

Local groups that previously provided administration and related services to traditional funds have expanded into the hedge fund market. Some players have carved out a niche for themselves by focusing on smaller hedge funds, which form the majority in Canada. The main Canadian banks, meanwhile, have assembled prime brokerage units and are expanding their offerings to match those of the local subsidiaries of international firms.

However, one area in which home-grown service providers have an advantage is the commodity sector, which has been the biggest contributor to the impressive performance of the Toronto Stock Exchange's benchmark composite index. In a country with barely CAD40bn of local hedge fund assets, compared with a global industry-wide total probably exceeding USD2.5trn, resources and energy stocks have created quite a buzz among momentum seekers, both at home and overseas.

It's hard to strike up a conversation with a Canada-focused manager without having the name Potash Corporation of Saskatchewan pop up. The big minerals company, with a market capitalisation of CAD66.4bn, has been a darling of hedge fund managers, who have seen its share price rise by 175 per cent in a year. It's a similar story with Calgary-based fertiliser manufacturer Agrium, which has gained 125 per cent in 12 months. Thanks to such stock market meteors, the securities lending desks of Canadian prime brokers have been in heavy demand.

'Canada has become more of a specialty play,' says Pierre Saint-Laurent, president of financial services consultancy AssetCounsel, which operates from Montreal and Toronto. 'It has built quite an offshore following and constituency by dint of the resources aspect, which has been a huge door-opener,' he adds, noting that diminishing supply and rising demand for many natural resources commodities bode well for Canada in the future.

The appeal of their resources expertise is enabling Canadian prime brokers to expand overseas, a trend driven by their clients. Managers are increasingly pitching their funds internationally via offshore vehicles and are making investments in other countries.

Royal Bank of Canada, for example, has made a dramatic push into the US, where its business is growing rapidly and now has 20 employees, mostly thanks to its acquisition of New York broker-dealer Carlin Financial Group in early 2007. 'Our US operation has totally flipped itself and is growing dramatically,' says Colin Bugler, a managing director with RBC Global Prime Services Group, which encompasses prime brokerage, financing, algorithmic trading and direct market access.

RBC is also placing a stronger focus on capital introduction both at home and overseas. Until last year, it ran that business more on an ad-hoc basis, according to Bugler, who says the bank's strategy is to introduce Canadian managers to investors in the US and other international markets and also to help pitch funds from international managers to investors at home.

The bank's prime brokerage business, which employs 11 professionals in Toronto, is expanding its electronic trading and execution capabilities to multiple asset classes. OptionsPro, its recently deployed options trading programme, is also gaining traction, Bugler says.

Similarly, Scotiabank is training its sights on expansion outside Canada, for example in Europe, where its capital markets unit now employs 10 people. 'What has worked particularly well is the securities lending side,' says Patrick Blessing, a director with Scotia Capital's prime brokerage business in Toronto. 'We're working with the global resources players that have significant exposure to Canada, in addition to European start-ups with assets of between USD10m and USD50m. We've been able to create a nice little niche.'

According to Blessing, Asia is another growth market for Scotia, which has established a five-member team in Singapore and is gradually increasing headcount there. At the outset, it is targeting smaller start-ups that require a higher level of service. 'We're trying to fill the niche that large prime brokers ignore,' he says.

Meanwhile, there's increasing demand for Scotia's hedge fund consulting services. Managers want greater direction in legal and compliance matters and are placing emphasis on establishing strong operational management and compliance systems. Says Blessing: 'Barriers to entry in this market are definitely getting higher.'

Canadian brokers have found a new sales pitch amid the credit market woes that have been escalating since July 2007, touting themselves as safer alternatives to their bigger US and European rivals, which so far have taken write-downs of nearly USD300bn linked mainly to the US sub-prime market and securitised products affected by the contagion. Canadian banks, by contrast, have announced much smaller losses, as a result of their limited exposure to such assets and conservative use of leverage.

As a result of the liquidity problems that led to US investment bank Bear Stearns being swallowed up by JPMorgan, counterparty risk has become a hot button issue both for managers and investors. Industry participants are 'making sure creditworthiness of counterparties is of the highest calibre,' says Jim McGovern, chief executive of Arrow Hedge Partners, a CAD1bn Toronto-based manager of hedge funds and funds of funds.

Within Canada, banks are also beefing up their services aimed at 130/30 funds. A number of long-only players are using the hybrid strategy as a stepping-stone to attract institutions and pension funds that seek alpha without the full-blown risk associated with investing in a hedge fund.

RBC Dexia, for example, has developed a tailored suite of products for 130/30, including global securities financing and custody, valuations and record-keeping, according to Brad Taylor, global head of investment finance and hedge fund services. He says the combination of the business's trustee services with the securities borrowing required to support the long/short strategy of these funds makes its offering unique.

RBC Dexia has also developed a transition process that provides wide-ranging support for asset managers as they deploy this strategy. 'We've supported 130/30 funds from initial concept and strategy incubation through to institutional investment,' Taylor says. At the end of the first quarter, RBC Dexia was providing financing and other services to 14 such funds.

Fund administration has perhaps been the most fertile area of hedge fund services in Canada. A number of international firms including Citco, Fulcrum Fund Services, Butterfield Fund Services, UBS, HSBC and Harmonic have set up offices in Toronto and the surrounding area to take advantage of competitive costs, an abundant and skilled local workforce and Toronto's proximity to New York and Stamford, Connecticut, the largest North American hedge fund hubs.

However, Halifax, the capital of Nova Scotia, is emerging as another centre for fund administration. With local government economic promotion agency Nova Scotia Business actively marketing Halifax and the authorities offering various tax concessions, new players are moving into Canada while existing players are looking to expand their operations from their Toronto base.

Expectations are high, with a handful of large international fund administration firms looking to hire hundreds of staff in Halifax alone. 'The opportunity is huge,' says Garvin Deokiesingh, an associate partner with Deloitte, who is helping expand the firm's presence in Halifax. The hope is that Halifax will draw business overflow from the Cayman Islands and other offshore jurisdictions such as Dublin that have been dogged by manpower shortages.

That's not to say that Toronto is losing its prominence as a centre for service providers. New entrants include Commonwealth Fund Services, was launched this year by local group Caledon Trust.

Commonwealth vice-president Alex Chapman, who sold his own fund administration firm, Mintz Fund Services, to Commonwealth in January, says some of his former customers are among the fledging firm's current roster of 15 clients. JC Clark, an investment manager with some CAD300m in assets that previously administered its own funds, now has outsourced that function to Commonwealth.

While third-party fund administration is the norm in Europe and Asia, it has been much less common in Canada, according to Chapman, but that is gradually changing. As managers establish offshore funds, they are becoming more comfortable with best practice standards that are widely followed elsewhere but have yet fully to take root at home, he says.

Meanwhile, Canada is revamping its registration requirements for investment managers under the proposed National Instrument 31-103. This introduces a new 'investment fund manager' registration category for any firm that directs the business, operations and affairs of an investment, whether private or public, and seeks to cover market dealers that previously were exempt from registration. The measure would also increase capital and insurance requirements as well as upgrade compliance, reporting and supervisory standards.

The review has been under discussion for nearly 18 months and is expected to be completed some time later this year. Following feedback from the industry, the regulator has gradually softened some of the original proposals. The window for a second round of comments on the latest draft came to an end last month.

According to attorney Lynn McGrade of Borden Ladner Gervais, the positive changes to the proposal include an exemption from the registration requirement for non-resident advisers of institutional clients. In addition, the 'fit and proper' and conduct requirements have been reduced for exempt market dealers which do not handle client assets.

'From a regulatory perspective, there's an increased focus on best practices in Canada,' McGrade says, noting that this new emphasis mirrors similar efforts undertaken by the President's Working Group on Financial Markets in the US and the Hedge Fund Working Group in the UK. She adds: 'It's a sign of evolution of the Canadian marketplace.'

While the new requirements are 'more onerous to some market participants', they will not hobble the industry's growth, according to Jennifer Wainwright, a partner at Toronto law firm Aird & Berlis, who says Canada's ongoing regulatory reform process has brought many different parties to the table: 'Everyone's committed to making it work.'

The industry is also grappling with changing accounting standards, says Gary Chin, the new head of Ernst & Young's 200-strong local asset management practice. Canada is moving from Generally Accepted Accounting Principles to International Financial Reporting Standards by 2011. One of the more significant issues associated with this transition is the valuation of investments that do not have a quoted market value, Chin says.

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