Go North, Young Fund!

Marketing Private Funds in Canada

DAVIES

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Canada is an attractive market for foreign private funds that wish to market to, and place their interests with, institutional or high-net-worth investors. Foreign private fund managers sometimes find themselves perplexed by the various rules and regulations that apply to their private placements in Canada. While these rules may at first appear confusing, a number of clear and well-trodden paths are available for foreign fund managers that wish to access the exempt market in Canada.

The marketing, offering and issuance of securities by foreign private funds in Canada are regulated under the securities regime established in each province or territory. Although each province and territory has its own securities regulatory regime, many of the applicable rules and regulations have been harmonized across Canada. Four principal regulatory "buckets" must be addressed by any private fund that seeks to place its interests with an investor in Canada:

1 **Prospectus Exemption.** Funds that are offering their interests to investors in Canada must ensure that a prospectus exemption is available in respect of the offering. The most typical exemption relied upon by foreign private funds is the "accredited investor" exemption.

2 **Dealer Registration Requirement.** Due to the nature of their businesses, open-ended funds such as hedge funds must involve a registered dealer in the placement of their securities in Canada. Many closed-end funds are able to take the position that they are not engaged in the business of trading in securities and are therefore not required to be registered as a dealer. However, for closed-end funds that are marketed through an affiliated dealing entity, that dealing entity may be subject to the dealer registration requirement unless an exemption is available.

3 **Adviser Registration Requirement.** The manager of a foreign fund that is managed from outside Canada is not required to register as an adviser. However, an adviser that advises a managed account or fund located in Canada would be caught by the adviser registration requirement.

4 **Investment Fund Manager Registration Requirement.** The manager of a private fund that is an "investment fund" for Canadian securities law purposes may be required to register as an investment fund manager. Private equity and venture capital funds may not be considered "investment funds" for Canadian securities law purposes if they are actively involved in the management of their portfolio companies. For managers of funds that fall within the definition of "investment fund" for Canadian securities law purposes, the Canadian securities regulators have not achieved consistency as to when the managers of such funds are required to register in the local jurisdiction. As a result, in the provinces of Ontario, Québec, and Newfoundland and Labrador, investment fund managers must register if any of their funds have issued securities in the local jurisdiction and they or their funds have actively solicited investors in that local jurisdiction, unless their investors and potential investors are "permitted clients" and certain other requirements are satisfied. In all the other provinces and territories of Canada, investment fund managers are not subject to the registration requirement unless they have a physical place of business or a head office in that province or territory.

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What's in a Trade: When Can I Market My Interests to Investors in Canada?

Provincial and territorial securities laws in Canada cast a wide net over what constitutes a "distribution" – that may be subject to the prospectus rules – and what constitutes a "trade" – that may be subject to the dealer registration rules.

- The definition of *distribution* includes a "trade" in securities that have not been previously issued. Canada has a "closed system," meaning that if the securities of a private issuer have not been qualified by a prospectus, any subsequent trades of such securities in a jurisdiction of Canada must generally qualify for a prospectus exemption. As a result, a secondary sale of a private fund's securities to an investor in Canada should be done in reliance on a prospectus exemption.
- The definition of *trade* includes any sale or disposition of a security for valuable consideration (subject to an exception for pledges and encumbrances) and any act, advertisement, solicitation, conduct or negotiation, directly or indirectly, in furtherance of the foregoing.

Unlike some other jurisdictions, provincial and territorial securities laws in Canada do not set out specific rules pertaining to "marketing" in the private fund context; nor do they provide any guidance as to when a private fund may engage in "pre-marketing" activities.

What should a foreign private fund do to navigate this "catch-all" regime? Some recommended approaches include the following:

- **Legends.** Fund managers should ensure that appropriate legends are included in the fund's private placement memorandum and marketing materials regarding the persons to whom the fund's interests are being offered, or the fact that the materials do not constitute an offer or solicitation.
- **Restricted Access.** The fund's private placement memorandum and marketing materials should be limited to investors who are accredited investors or permitted clients. Websites on which the fund's private placement memorandum or marketing materials are posted should be password-protected and require persons who access those websites to represent that they are accredited investors.

– **Registered Dealer.** The fund should ensure that the persons who are engaged in marketing activities on behalf of the fund either are registered as dealers in the province or territory in which such activities are being carried out or are not subject to the dealer registration requirement.

– **Registered Investment Fund Manager.** The fund's sponsor or manager should ensure that, if it is subject to the investment fund manager registration requirement, it is or will be registered or that it is able to avail itself of an exemption from registration as an investment fund manager.

Prospectus Exemptions

ACCREDITED INVESTOR OR PERMITTED CLIENT?

Foreign private funds generally rely on the "accredited investor" exemption from the prospectus requirements in connection with the issuance of their securities to investors in Canada, although some foreign private funds limit their distributions even further to Canadian investors that are "permitted clients" in order to rely on exemptions from certain registration requirements under Canadian securities laws.

– *Accredited investors* are purchasers that are presumed to be sophisticated because they possess certain characteristics that minimize their need for the additional information provided by a prospectus. The definition of "accredited investor" includes the following:

> an individual, either alone or with a spouse, who beneficially owns financial assets having a pre-tax aggregate realizable value that, net of any related liabilities, exceeds C$1 million or who, either alone or with a spouse, has net assets of at least C$5 million;

> an individual whose net income before taxes exceeded C$200,000 in each of the two most recent calendar years or whose net income before taxes combined with that of a spouse exceeded C$300,000 in each of the two most recent calendar years and who reasonably expects to exceed that net income level in the current calendar year;

> a person, other than an individual or investment fund, that has net assets of at least C$5 million as shown on its most recently prepared financial statements, provided that such person is not created or used solely to purchase or hold securities as an "accredited investor";

> certain types of investment funds, financial institutions, pension funds and governmental entities; and

> registered dealers and advisers and persons acting on behalf of fully managed accounts managed by those persons, if those persons are registered or authorized to carry on business as advisers or the equivalent under the securities legislation of a jurisdiction of Canada or a foreign jurisdiction.

Accredited investors are purchasers that are presumed to be sophisticated because they possess certain characteristics that minimize their need for the additional information provided by a prospectus.

– *Permitted clients* are practically a subset of accredited investors that are presumed to be even more sophisticated than accredited investors and that therefore require even less protection under the law. As set forth in more detail below, reliance on the following exemptions depends on fund investors and potential investors being permitted clients: "international dealer" exemption from the dealer registration requirement; the "international adviser" exemption from the adviser registration requirement; and the exemption in certain provinces from the investment fund manager registration requirement. The definition of "permitted client" includes most types of institutional investors, entities other than investment funds with net assets of at least C$25 million and individuals who beneficially own financial assets with a pre-tax aggregate realizable value, net of any related liabilities, in excess of C$5 million.

MINIMUM INVESTMENT EXEMPTION

Foreign private funds may also rely on an exemption from the prospectus requirement that allows securities to be offered for sale without a prospectus to any entity that purchases as principal securities having an aggregate acquisition cost of not less than C$150,000. To rely on this exemption, the purchaser must pay the consideration in cash at the time of the distribution and the purchaser must not have been created or used solely to purchase or hold securities on that basis. An issuer is not permitted to rely on the exemption if the purchaser is an individual.

Owing to the requirement that the consideration be paid "at the time of the distribution," commitment-based funds that draw down capital on an as-needed basis may not be able to rely on this exemption.

In addition, funds or fund managers that intend to rely on the international dealer exemption (and the permitted client exemption from the investment fund manager registration requirement) would not rely on this exemption because they are entitled to deal only with permitted clients.

REPORT OF EXEMPT DISTRIBUTION

In each of the provinces, a report of an exempt distribution must be filed with the relevant regulator along with the prescribed filing fee when a distribution is made in reliance on certain exemptions from the prospectus requirements, including the accredited investor exemption and the minimum amount exemption. Generally, the reports must be filed within 10 days of a distribution; however, an investment fund is permitted to file the report within 30 days of the end of the calendar year in which the distribution was made. The report includes information about the issuer, the securities, the purchasers and the exemptions relied upon. Depending on the province and the prospectus exemption relied upon, the fund may also be required to file the offering document delivered to Canadian purchasers. While it is generally the policy of the provincial securities commissions to treat information relating to purchasers as confidential, in certain provinces, the relevant securities regulatory authority may have to make this information available if requested, in accordance with applicable freedom of information legislation.

OFFERING DOCUMENTS

The exemptions from the prospectus requirements described above do not require that an offering document be provided or that the offering document, if provided, be in a particular form. The term "offering memorandum" is broadly defined under Canadian securities law and includes any form of offering or informational document. The distribution of securities under an offering memorandum is subject to statutory liability in many Canadian jurisdictions. It is generally recommended that an offering document be provided

in a standardized form (with any disclosure required by Canadian securities law being provided in a supplement or amendment to the offering document that is provided only to Canadian investors) so that all investors are given the same information about their investment.

Managers of foreign private funds, either directly or through a registered dealer, will most often furnish Canadian investors with their standard form of offering document that is "wrapped" with a short supplement containing the requisite additional Canadian disclosure, or, less often, one omnibus offering memorandum drafted explicitly for global use, including for the Canadian market. Although certain disclosure requirements that apply to Canadian registrants are not required for foreign funds, many foreign funds offering their securities in Canada subscribe to best practices and include much of the disclosure provided by Canadian registrants.

Additional Canadian-specific disclosure in an offering document for the Canadian market may include the following:

- **Statutory Rights of Action.** Information to the effect that purchasers in certain provinces may have statutory rights of action for rescission or damages where an offering memorandum contains a misrepresentation.

- **Resale Restrictions.** Details of applicable resale restrictions for securities purchased under an offering document in a prospectus-exempt offering.

- **Collection of Information.** Notice must be given that the personal information of each purchaser will be collected and provided to the applicable Canadian securities regulators and, under certain freedom of information laws, potentially to the public.

- **Registration Exemptions.** The disclosure required to rely on certain dealer, adviser and investment fund manager exemptions, as described below.

- **Tax Disclosure.** Where the tax treatment of the securities in the hands of Canadian holders differs materially from the tax treatment in the hands of non-Canadian resident investors, Canadian tax disclosure is often included.

- **Deemed Representations.** The fund may also include "deemed representations" from purchasers to support the issuer's reliance on the relevant private placement and registration exemptions as well as in respect of the indirect collection of personal information through mandatory sales reports; unless the fund's Canadian investors are well-known institutional investors, the fund should also obtain accredited investor and permitted client representations from its Canadian investors in the subscription agreement (or a supplement to the subscription agreement).

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Dealer Registration Requirement

TRIPPING THE BUSINESS TRIGGER

The requirement to register as a dealer in a province or territory depends on whether the fund or fund manager meets the "business trigger." If a fund or its manager engages in or holds itself out as engaging in the business of trading securities in a province or territory of Canada, then it should register as a dealer in that province or territory. Trading is defined very broadly under Canadian securities laws and includes any sale or disposition of a security and any act, advertisement, solicitation, conduct or negotiation to facilitate a sale or other disposition of a security.

The Canadian Securities Administrators (CSA) has stated that it will examine a particular activity to determine whether it is carried on for a business purpose. The CSA has identified several factors that provide guidance as to whether a market participant trips the business trigger, including (i) frequency of trading, (ii) holding oneself out as trading in securities, (iii) expecting to be compensated for trading, (iv) intermediating trades or acting as a market maker, and (v) soliciting trades.

A private fund that issues its own securities to investors (or its manager) may have to register as a dealer if the fund frequently issues its securities to investors, including as a result of being an open-ended fund; and a manager may also have to register as a dealer if it frequently raises capital for closed-end funds. Accordingly, a manager of an open-ended fund, which is, practically speaking, always in the market, is generally required to register as a dealer or involve a registered dealer in its trades unless an exemption is available. The fact that an open-ended fund may deal infrequently with prospective investors in Canada does not affect the analysis of whether such fund or its manager is in the business of trading in securities.

Private equity funds, venture capital funds, infrastructure funds, certain private credit funds, real estate funds and some other pooled fund entities are often not required to register or avail themselves of an exemption from the dealer registration requirement when considering the above-noted factors.

The analysis of whether a fund or its manager meets the business trigger requires a careful examination of its activities and must be done on a case-by-case basis. When the dealer registration requirement applies, foreign private funds typically register as an "exempt market dealer," rely on the "international dealer" exemption or hire a Canadian dealer.

Some funds that are unable to rely on the international dealer exemption (and prefer not to register as an exempt market dealer) choose instead to engage a registered dealer in the local jurisdiction to facilitate the trade.

INTERNATIONAL DEALER EXEMPTION

The *international dealer exemption* permits a qualifying non-Canadian dealer to engage in trades of foreign securities made to permitted clients in Canada.

- One of the conditions of the exemption is that the person be registered under the securities legislation of its home jurisdiction in a category of registration that permits it to carry on the activities that it is proposing to carry on in the local Canadian jurisdiction. Many U.S. hedge funds, including those registered under the *Advisers Act*, are unable to satisfy this exemption because they are not in fact registered to carry on business as dealers in their home jurisdictions.
- The process for relying on the international dealer exemption is straightforward and can be completed relatively quickly. As part of the process, international dealers are required to submit to the jurisdiction of the regulator in the applicable province or territory and to appoint an agent for service of process.
- International dealers are also required to make certain disclosures to the permitted clients with whom they deal, including prescribed disclosure to the effect that they are not registered in the local jurisdiction and that there may be difficulty enforcing legal rights against them.

EXEMPT MARKET DEALER

Registration as an *exempt market dealer* would permit a fund or its manager to conduct marketing activities and to act as a dealer in respect of the interests of the fund that are being issued under an exemption from the prospectus requirement. Registration as an exempt market dealer involves an extensive application procedure for the entity, certain officers and shareholders and the individuals carrying on the registrable activities on behalf of the entity.

The process typically takes at least 8 to 12 weeks and possibly longer when exemptions are needed from the proficiency or other requirements. An exempt market dealer and its registered individuals are subject to minimum proficiency and professional qualification requirements; and an exempt market dealer is subject to ongoing financial and reporting requirements and ongoing conduct and compliance obligations.

A fund or fund manager that registers as an exempt market dealer or that relies on the international dealer exemption will be subject to monthly anti-money laundering (AML) reporting obligations in Canada, as described below, and will be required to submit an annual filing in each province or territory where it is registered or has relied on the exemption. Each province or territory has a different fee regime that applies to participants in the securities market in that province or territory. In Ontario, a registered dealer and each person that is relying on the international dealer exemption is required to pay an annual participation fee that is based on gross revenues derived from capital markets in Ontario, subject to a minimum.

NO REGISTRATION? NO PROBLEM! THE "HIRE A DEALER" ALTERNATIVE

Some funds that are unable to rely on the international dealer exemption (and prefer not to register as an exempt market dealer) choose instead to engage a registered dealer in the local jurisdiction to facilitate the trade. The advantage of this approach is that it avoids the need to limit the offering to permitted clients. The disadvantage of this approach is that the registered dealer will charge a fee for its services, and all active solicitation of potential investors must be conducted by the registered dealer and not by fund and its manager.

If a registered dealer is engaged, then care should be taken to ensure that the dealer is involved from the beginning in soliciting and marketing activities in Canada – this may include the dealer participating in meetings and telephone calls with potential investors and should include the dealer's review and distribution of the fund's marketing materials to investors.

Adviser Registration Requirement: Only in (or to) Canada

Any person engaging in or holding itself out as engaging in the business of advising another with respect to an investment in or the purchase or sale of securities or in the business of managing a *securities portfolio* must be registered as an adviser. Advice that is both given and received outside Canada is not subject to the adviser registration requirement. Generally, any advice that is given by a fund manager is given to the fund itself, and not to the fund's investors directly. Accordingly, the adviser registration requirement typically does not apply to the manager of a fund if both the manager and the fund are located outside Canada.

The analysis is different for managed accounts. In the case of a managed account in Canada, the adviser registration requirement does apply because the advice is being given to a recipient in Canada. An international adviser exemption is available from the adviser registration requirements for advisers located outside Canada. The exemption is similar to the international dealer exemption, in that it requires the adviser to advise only permitted clients. Some other conditions to the exemption include the following:

Any person engaging in or holding itself out as engaging in the business of advising another with respect to an investment in or the purchase or sale of securities or in the business of managing a securities portfolio must be registered as an adviser.

- the adviser must not be advising its client on securities of Canadian issuers unless providing that advice is incidental to its providing advice on a *foreign security*[1]
- the adviser must be registered in, or operate under an exemption from the securities legislation of, its home jurisdiction in a category that permits the adviser to carry on the activities that it is proposing to carry on in the local Canadian jurisdiction; and
- the adviser must not, during its most recently completed financial year, have derived more than 10% of its aggregate consolidated gross revenue (including revenue of its affiliates and affiliated partnerships) from Canadian advising and portfolio management activities.[2]

1 A "foreign security" is a security issued by (i) an issuer incorporated, formed or created under the laws of a foreign jurisdiction or (ii) a government of a foreign jurisdiction.

2 The term "portfolio management activities" is not specifically defined under Canadian securities laws, but generally involves "engaging in the business of advising others as to the investing in or the buying or selling of securities."

The process for relying on the international adviser exemption is similar to the process for relying on the international dealer exemption described above, and similar fees are payable.

A fund manager that claims the international adviser exemption will be subject to monthly AML reporting obligations in Canada, as described below, as well as an annual filing. In Ontario, a registered adviser and each adviser that is relying on the international adviser exemption is required to pay an annual participation fee that is based on gross revenues derived from capital markets in Ontario, subject to a minimum.

Navigating the Investment Fund Manager Requirements

WHEN IS A FUND AN INVESTMENT FUND?

The requirement to register as an investment fund manager (IFM) in Canada depends on three factors. First, is the fund that the manager manages an investment fund for the purposes of Canadian securities laws? Second, is the fund managed from within a province or territory of Canada? Third, in which provinces and territories is an investment fund offering its securities?

The definition of "investment fund" is not intuitive. Traditional mutual funds are caught by the definition, as are "non-redeemable investment funds," defined as an issuer (other than a mutual fund) whose primary purpose is to invest money provided by its securityholders and that does not invest (i) for the purpose of exercising or seeking to exercise control of an issuer, or (ii) for the purpose of being actively involved in the management of any issuer in which it invests, in each case, other than an issuer that is a mutual fund or a non-redeemable investment fund.

Most private equity and venture capital funds, for example, do not fall within the definition of investment fund because they invest either for the purpose of exercising or seeking to exercise control of the issuer or for the purpose of being actively involved in the management of their portfolio companies. In contrast, a hedge fund, which engages in an investment strategy that does not depend on control or involvement in management, would typically be caught by the definition.

Registration as an investment fund manager is required only by a person that directs or manages the business, operations or affairs of an investment fund from a physical place of business in that province or territory in a way that establishes a substantial connection to that jurisdiction, or when its head office is in that province or territory. In addition, managers of investment funds that offer securities to investors in the provinces of Ontario, Québec, and Newfoundland and Labrador are deemed to be acting as investment fund managers in the jurisdiction unless they have not actively solicited any investors in that jurisdiction.

An exemption similar to the international dealer and international adviser exemptions is available to international investment fund managers that manage private funds in the provinces of Ontario, Québec, and Newfoundland and Labrador. The exemption applies only if the investment funds sponsored by such manager have distributed securities in the local jurisdiction only to permitted clients. The process for relying on the international fund manager exemption is similar to the process for relying on the international dealer exemption and the international adviser exemption described above, and similar fees are payable.

Additional Considerations

PAY TO PLAY OBLIGATIONS

Canada has not developed “pay to play” rules similar to those of some states and municipalities in the United States. Accordingly, investment funds and their managers are not constrained by restrictions on the payment of placement fees to placement agents or communications with prospective investors that are governmental entities or public pension plans.

AML MONTHLY REPORTING OBLIGATIONS

Once a dealer or adviser becomes a registrant or relies on one of the exemptions from registration, it is required to file a Monthly Suppression of Terrorism and UN Sanctions Report confirming that it has had no dealings with certain “designated persons.” This report is made only in respect of the registrant’s (or the exempt entity’s) dealings with its Canadian clients.

In order to comply with the monthly reporting requirement referred to above, registrants and exempt entities should obtain appropriate representations from each of their clients that it is not a designated person, and that the client will advise the registrant or exempt entity if at any time that ceases to be the case.

EXTRAPROVINCIAL LICENCES

Private funds that market their interests to investors in Canada may also need to register extraprovincially in the provinces or territories where they are active. For example, a limited partnership that issues securities to a person in Ontario is required to register extraprovincially in Ontario. In addition, persons that “carry on business” in a particular province or territory may be required to register. Each province and territory has its own regime for such registrations and a different test as to when an extraprovincial registration or licence is required.

PRESCRIBED FEES

Each province and territory has its own prescribed fees that a fund or registrant must pay to register, maintain registration, issue securities and file other various forms and applications, as described above. An annual participation fee is payable for registered firms as well as for firms relying on an exemption from registration in Ontario. This fee is based on gross revenue derived from capital market activities in Ontario, subject to a minimum fee.

Investment funds and their managers are not constrained by restrictions on the payment of placement fees to placement agents or communications with prospective investors that are governmental entities or public pension plans.

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