

Registration

AIMA Canada Handbook Provides Roadmap for Hedge Fund Managers Doing Business in Canada

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Pershing Square's successful proxy contest for control of Canadian Pacific Railway is the most prominent recent example, but by no means the only example, of the increasing importance of Canada for hedge fund managers. See also "[Ontario Securities Commission Sanctions Hedge Fund Manager Sextant Capital Management and its Principal for Breach of Fiduciary Duty](#)," *Hedge Fund Law Report*, Vol. 5, No. 24 (Jun. 14, 2012). Specifically, Canada is growing in importance as a place where hedge fund managers may invest, raise capital and recruit talent. In an effort to assist hedge fund managers in navigating the Canadian tax and regulatory landscape, AIMA Canada, a chapter of the Alternative Investment Management Association (AIMA), recently published the [AIMA Canada Handbook](#) (Handbook). This article summarizes the key topics covered in the Handbook, including a background discussion of the Canadian securities industry; registration requirements for fund managers operating in Canada; regulations applicable to registrants; exemptions from fund manager registration; tax consequences for hedge funds and investors; structuring Canadian hedge funds; and the outlook for the Canadian hedge fund industry, including an update on the capital raising environment.

Regulatory Overview

The Handbook provides an excellent overview of the Canadian securities industry registration and regulation regime. Unlike the United States, Canada has no central regulatory authority for securities. Canada has ten provinces and three territories, each of which has its own laws, rules and regulations that are administered by a regulatory authority. The administrators in those jurisdictions attempt to coordinate policy and educate Canadians about the securities industry through an informal association, the Canadian Securities Administrators (CSA). In 2009, in coordination with the CSA, Canada enacted National Instrument 31-103 (NI 31-103), aimed in part at harmonizing certain registration requirements and registration exemptions among the 13 different jurisdictions. The Handbook cites Canada's strong system of regulation as a reason that it is an attractive jurisdiction for hedge fund investors.

The Handbook describes three categories of registration that are likely to apply to hedge fund managers operating in Canada:

- **Dealer Registration.** A person is required to register as a dealer when that person is in the "business of trading" in securities. The dealer must register in every jurisdiction where a

purchaser resides. A hedge fund manager typically registers as an “exempt market dealer” (EMD), which may trade under a “prospectus exemption” or with certain exempt individuals (such as accredited investors). A manager may also register as an “investment dealer,” which has much greater trading authority: An investment dealer “may trade in virtually any security with any client (subject to ‘know your client’ criteria and the appropriateness of each trade).”

- *Adviser Registration.* This registration requirement is triggered when a person is in the business of giving advice on the purchase and sale of securities. Consequently, a person providing investment advice to a Canadian fund must register as an adviser in the jurisdiction where the fund is managed. There are exemptions for certain international advisers and sub-advisers. The domicile of the individual fund investors is not considered in determining whether registration is required: A foreign-domiciled adviser that provides advice to a foreign-domiciled fund would not usually need to register, even if the fund had Canadian investors.
- *Investment Fund Manager (IFM) Registration.* A person that “direct[s] the business, operations or affairs” of a fund must register as an IFM in the jurisdiction of the fund’s head office and in each province where the fund has investors or has solicited investments. The requirement to register in other than the head office jurisdiction has been suspended through September 2012.

In determining whether registration as a dealer or adviser is required, Canadian regulators look to whether the activity is conducted for a business purpose. This is known as the “business trigger.” The Handbook notes several activities that might trigger the registration requirement, including promoting or advising with respect to securities transactions; acting as an intermediary in securities transactions; or receiving compensation for such activities. The frequency of those activities is also a factor. There is no business trigger for investment fund managers. All entities that manage the “day to day business and affairs” of a fund must register. Registration fees vary from jurisdiction to jurisdiction.

Registrants are subject to various compliance duties relating to reporting, recordkeeping and other matters. The Handbook notes that each category of registrants is subject to a separate “detailed set of proficiency, minimum capital, insurance, record keeping, financial reporting, conflict of interest, annual fee and other compliance requirements.” As in the U.S., fund managers doing business in Canada are also subject to privacy legislation. The Handbook identifies several specific recordkeeping and reporting requirements that may apply to fund managers that operate in Canada. They include, among others, the following:

- Registrants must make periodic financial and account activity reports under NI 31-103.
- Managers of funds relying on certain private placement exemptions to registration of securities must file a “Report of Exempt Distribution” in each jurisdiction in which they sell fund interests to an investor.
- Fund managers are subject to Canada’s anti-terrorism and anti-money laundering laws and United Nations sanctions regulations and are therefore subject to certain reporting, filing, record-keeping, client identification and compliance requirements in addition to certain monitoring requirements and restrictions from dealing with certain designated individuals and groups.

Exemptions from Registration for Fund Managers

International Dealers

According to the Handbook, this exemption, set out in Section 8.18 of NI 31-103, “allows non-Canadian dealers who are registered to deal in securities in the jurisdiction where their principal place of business is located to provide restricted services to permitted clients without having to register under NI 31-103.” The exemption is limited primarily to transactions in foreign securities. “Permitted client” is defined under NI 31-103 to include, among other things, various government and financial institutions; registered advisers and dealers; and individuals with over \$5 million in net worth.

The Handbook suggests that this exemption might be available to foreign fund managers who wish to market foreign funds in Canada. However, given the high threshold for permitted clients and other stringent criteria to qualify for the exemption, the Handbook notes that “it may be necessary to engage either an entity which is able to rely on the international dealer exemption (in respect of trades with permitted clients) or a locally registered dealer to intermediate the investment by Canadian residents in the Foreign Fund.”

Temporary Exemption for Foreign Fund Managers

There is currently an exemption from registration for fund managers whose head office is not located in Canada. That exemption is set to expire September 28, 2012, and may be replaced with new policies: Multilateral Instrument 32-102 and Multilateral Policy 31-202. Under the first, a foreign fund manager would have to register in one of four Canadian jurisdictions (Ontario, Quebec, New Brunswick and Newfoundland and Labrador) if the manager solicits investors there. Under the second, covering the other nine jurisdictions, the manager would have to register if it “carries on the functions and activities of an investment fund manager in that jurisdiction” or maintains a principal place of business or an office there for that purpose.

Use of Offering Memoranda

According to the Handbook, Canadian hedge funds whose securities are sold to the “exempt market” generally do not require an offering memorandum (OM) to be provided to investors although most hedge funds generally supply some type of marketing document to investors. If an OM is provided to investors, it must be filed “with the appropriate securities regulator.” As such, the Handbook cautions: “Care should be exercised in relation to marketing materials which are provided to potential purchasers in Canada to ensure that they would not be considered to be an offering memorandum under Canadian securities laws.” Several jurisdictions provide statutory rights of action for Canadian investors who are adversely affected by misrepresentations in OMs. (Foreign investors in Canadian funds may be limited to common law rights of action.) As in the U.S., “misrepresentation” is typically defined to include a misstatement of a material fact or the failure to state a material fact. For instance, under the Ontario Securities Act, a misrepresentation is defined as “(a) an untrue statement of material fact, or (b) an omission to state a material fact that is required to be stated or that is necessary to make a statement not misleading in the light of the circumstances in which it was made. . . .” That closely parallels the language of Rule 10b-5 under the Securities Exchange Act of 1934. When used, OMs need to be customized to include certain disclosures required by the Canadian jurisdictions where they will be circulated.

Taxation of Hedge Funds

Foreign Investors in Canadian Funds

Foreign investors in Canadian funds may be subject to local tax “to the extent that the investor is considered to carry on business in Canada.” A foreign investor may also be subject to tax on gains from the disposition of certain real estate or natural resource property interests, known as “taxable Canadian property.” In the absence of a tax treaty specifying a lower rate, distributions of income from Canadian funds to foreign investors are generally subject to a 25% withholding requirement. Gains on sales of Canadian fund interests may also be taxable if they constitute “taxable Canadian property.” Canadian partnerships with foreign investors may be subject to adverse tax consequences, so Canadian corporations are often used by foreign investors to make investments in Canadian partnerships.

Safe Harbor for Foreign Funds

Foreign funds deemed to be “carrying on business” in Canada are subject to tax in Canada. There are safe harbor rules that prevent a foreign fund from being taxed in Canada “solely by virtue of engaging Canadian service providers.” The rules apply to “designated investment services” relating to “qualified investments.” The designated services cover the spectrum of hedge fund manager operations, including investment management, brokerage, marketing and associated back-office and custodial work. The Handbook notes that “qualified investments” covers a broad range of securities, but that securities relating to natural resources and real estate may not qualify. It also notes that, in addition to benefiting foreign funds that desire to retain Canadian service providers, the safe harbor rules could also benefit a Canadian investment manager that desires to form a foreign fund.

Feeder Funds

If a foreign fund desires to raise capital from Canadian investors, the Handbook notes that use of a Canadian-based feeder fund may be advisable. First, it could help avoid running afoul of the safe harbor rules noted above. Moreover, direct investment into a foreign fund could complicate tax compliance by its Canadian investors and subject the fund to additional “information requirements.”

Investments in Canadian Companies

As with distributions from Canadian funds to foreign investors, certain distributions of Canada source income to foreign funds are subject to a 25% withholding requirement (or lower rate, if a tax treaty applies). However, income from publicly-traded shares and mutual fund interests are generally exempt from withholding.

Canadian Hedge Funds

Structure

Canadian hedge funds can be structured as corporations, limited partnerships (LPs) and unit trusts, with the latter two forms being the most popular. Unit trusts are often used to accept

investments from non-taxable entities such as registered retirement plans (which are generally prohibited from investing in LPs) and foundations. The Handbook notes that a fund that desires to accept investments from registered retirement plans must be redeemable on demand or be registered under Canada's Income Tax Act. Moreover, there are restrictions on the types of investments that the fund may make. As in the U.S. and elsewhere, trusts and LPs are tax pass-through vehicles and, as such, may result in "phantom income" to investors if income is passed through for tax purposes without a corresponding cash distribution. While master-feeder structures are "not typical," "layering" of investment entities is possible with careful planning to achieve various investment and fund-raising goals. Funds of funds are also common.

Fund Operations

The Handbook reveals that funds operate in largely the same manner as U.S. funds and funds established in other jurisdictions. As indicated above, OMs are generally not required in sales to the "exempt market," though most funds use "some form of marketing document." Canadian funds usually permit monthly redemptions (which is more frequent than U.S. and other funds) and have provisions similar to those of U.S. funds for suspending redemptions and invoking gates. Fees are based on the "2 + 20" model. Performance fees may be capped, but it is less common for a Canadian fund to have a performance "hurdle rate." Early redemption fees are also used. The Handbook cautions that side letters are a "litigation minefield" in Canada and should be avoided. It recommends the use of separate classes of fund shares as an alternative. Side pockets are also problematic because they may cause tax complications. Fund financials must be prepared in accordance with Canadian Generally Accepted Accounting Principles. Ontario funds are subject to additional disclosure requirements, including the preparation of annual audited and semi-annual unaudited financial statements. The Handbook points out that Canada is likely to require compliance with the International Financial Reporting Standards starting in 2014.

Foreign Investors

A foreign investor in a Canadian fund may not be subject to Canadian investor qualification rules as long as the fund takes "reasonable precautions" to assure that the securities will not be re-distributed in Canada. However, the fund should still be sure that the investor is qualified under the rules of his or her home jurisdiction.

Outlook for Canada's Alternative Investment Sector

The Handbook points out that Canada has approximately 250 alternative investment funds, only 15% of which have more than \$100 million under management. It notes that Canada's alternative investment sector has been growing due, in part, to "a compressed yield environment in long-only credit instruments, generally rangebound global equity markets, and the desire to buttress a portfolio with noncorrelated sources of return . . ." The alternative investment sector in Canada has been gradually moving away from traditional "long-based equity" management. This presents opportunities for "emerging managers."

The Handbook reports that there are also growing opportunities to raise funds from Canadian investors. First, institutional investors have traditionally invested through funds of funds and have avoided funds with less than \$1 billion under management. Institutional investors are gradually becoming more receptive to direct investments and investments with smaller funds.

Second, Canada has over 300,000 individuals with more than \$1 million of net assets available for investment. Those individuals are said to be more likely to work with funds of all sizes. Finally, the Handbook points to possible opportunities at the retail investor level if funds are willing to work through the existing Canadian bank-owned broker-dealer network and comply with certain “stringent requirements” that apply to those retail networks.

For a copy of the AIMA Canada Handbook, [click here](#).

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