Hedge Fund Law Report
An Acuris company

Marketing

How U.S. Managers Can Raise Capital in Canada While Complying With Local Laws (Part One of Two)

Apr. 27, 2017
By Kara Bingham, *Hedge Fund Law Report*

Over the past decade, several factors have caused U.S. private fund advisers to become considerably more aware that many countries have laws restricting a foreign adviser's ability to market to investors in those jurisdictions. See "K&L Gates Partners Offer Practical Guidance for Hedge Fund Managers on Raising Capital in Australia, the Middle East and Asia" (Oct. 30, 2014). The enhanced attention paid to this issue is likely a result of multiple factors. Since the enactment of the Dodd-Frank Act, advisers to private funds have spent substantial resources building out their legal and compliance teams with experienced professionals that are trained to identify these sorts of extra-territorial risks. The implementation of the Alternative Investment Fund Managers Directive also placed a renewed spotlight on private placement regimes, as it forced non-E.U. managers to consider the private placement regime in each E.U. member state where they sought to market their funds.

European countries are not the only jurisdictions that restrict a foreign manager's ability to market to local investors. Canada has also long since maintained a comprehensive regulatory framework applicable to both Canadian-based and foreign asset managers seeking to raise capital from local investors. While non-resident advisers generally view compliance with Canada's rules as manageable, they must still contend with a number of regulatory hurdles.

In this two-part series, the Hedge Fund Law Report has identified the key registration issues, as well as ongoing regulatory and filing obligations, that may apply to non-Canadian managers seeking to raise capital in Canada. This first installment discusses two registration requirements that all private fund advisers should consider prior to marketing their funds to Canadian investors. The second article will explore a third registration requirement triggered in the managed account context, as well as a variety of additional rules U.S. managers may need to comply with when marketing their funds, including regarding appending a "wrapper" to an offering document, making periodical filings and paying ongoing fees.

For additional insight about Canada's regulation of the fund industry, see "AIMA Canada Handbook Provides Roadmap for Hedge Fund Managers Doing Business in Canada" (Sep. 13, 2012).

Structure of Canadian Securities Laws

The law-making authority in Canada is similar to its American counterpart in that the power to enact legislation is split between the federal government and the local provincial and territorial governments. Unlike the U.S., however, securities regulations may only be adopted at the provincial and territorial level, which theoretically means that securities laws could differ across all 13 jurisdictions. This makes it difficult for advisers to do business across Canada. Fortunately, at least in the asset management sector, many (but not all) of the regulations have been harmonized across the provinces and territories through the use of "National Instruments."

"The Canadian Securities Administrators (CSA) is an umbrella organization that includes representatives from each of the Canadian provincial and territorial securities regulators," explained Michael Bunn, a partner at Norton Rose Fulbright. "The CSA's mandate is to assist the various jurisdictions to adopt standardized rules and practices for the securities industry, and this is typically accomplished through the issuance of National Instruments."

Once approved, National Instruments have the force of law in Canada and are then adopted by each of the jurisdictions, explained Borden Ladner Gervais partner Prema Thiele. The rules, regulations and standards set forth in National Instruments are typically adopted in their final forms; therefore, local regulators do not generally seek to add to or "gold plate" the standards. "Rather, any differences as to how a National Instrument is to be applied in a particular jurisdiction would be set forth in the National Instrument," explained Thiele.

National Instrument 31-103 sets forth the registration requirements, exemptions and ongoing obligations relating to the three registration requirements discussed in this series: investment fund manager, dealer and investment adviser.

Investment Fund Manager Registration

When U.S. managers consider marketing non-Canadian "investment funds" to Canadian investors, the first Canadian registration requirement that generally should be considered is the investment fund manager (IFM) regime, Thiele explained. "This is a pillar of registration unique to Canada, and a manager is captured by the regime simply by serving as an investment manager to an investment fund," she added.

The IFM registration requirement, explained Stikeman Elliot partner Jeffrey Elliott, only applies to a manager of an investment fund, and notably, the regulators have distinguished private equity funds from investment funds. In Canada, an investment fund is generally defined as a passive investment vehicle and, as such, excludes traditional private equity and activist funds. Only managers to hedge funds, therefore, typically need to contend with the IFM registration requirement.

The requirement to register as an IFM is triggered when a person or company is "acting as an IFM" in the applicable Canadian province or territory, explained Elliott. The IFM is the entity within the fund complex that manages the business, operations or affairs of an investment fund. Examples of activities typically within the IFM's purview include:

- marketing the fund;
- establishing and overseeing the fund's compliance and risk-management programs;
- retaining the fund's service providers, such as custodians and dealers;
- preparing the fund's offering documents; and
- calculating the fund's net asset value.

Determining which entity in the complex should be designated as the IFM may not be obvious. There is not always an entity within the manager's organizational structure that squarely fits within the IFM category, Elliott noted. When this is the case, "we review the fund's constituent documents to determine which entity is responsible for the types of activities that are typically performed by an IFM, as well as consider which entity is best suited to be the IFM or best resembles an IFM," he explained.

Critically, it should be noted that the IFM registration regime is an area in which the securities laws diverge between the provinces and territories. "In Quebec, Ontario and Newfoundland and Labrador (collectively, the Relevant Jurisdictions), the IFM registration requirement is triggered by a non-resident IFM distributing the investment fund's securities to residents in these jurisdictions, in which case the IFM either needs to register as an IFM in the jurisdiction where the distribution is taking place, or perfect an exemption from the IFM registration requirement," Thiele explained.

"A distribution," Thiele elaborated, "is a trade, and any act in furtherance of a trade is a trade." The marketing of an investment fund by an IFM to investors in the Relevant Jurisdictions, therefore, constitutes a distribution by the fund and would require the manager to register as an IFM or rely upon an available exemption.

The remaining 10 provinces and territories, Elliott noted, have taken an entirely different approach. "In these jurisdictions, registration is triggered by the manager acting as an IFM within the province or territory," clarified Elliott. Accordingly, as long as the investment manager is carrying on the business, operations and affairs of the investment fund outside of Canada, there is no requirement to register as an IFM or elect an available exemption in those jurisdictions.

Permitted Client Exemption

When acting as an IFM in the Relevant Jurisdictions, a non-resident IFM can avail itself of an exemption if it agrees to restrict solicitation activities to "permitted clients," explained Sean Sadler, a partner at McCarthy Tétrault. Permitted clients[1] generally include institutional investors, such as pension plans and governmental entities; entities with net assets of at least CAD$25 million; and individuals who beneficially own at least CAD$5 million in financial assets.

"The permitted client exemption can be easily perfected by most U.S. hedge fund managers," noted Sadler. To rely upon the exemption, Sadler explained that all of the following must apply to the IFM:

- its head office and its principal place of business must be outside of Canada;
- it must be formed in a jurisdiction other than Canada;
- none of the investment funds may be a reporting issuer in any Canadian jurisdiction;
- it must submit a Form 32-102F1 – Submission to Jurisdiction and Appointment of Agent for Services for International Investment Fund Manager – to the securities regulatory authority in the Relevant Jurisdiction; and
- it must provide certain disclosures in writing to permitted clients, including that the IFM is not registered in the local jurisdiction to act as an IFM; the location of the IFM's head office or principal place of business; the fact that all or substantially all of the assets of the IFM may be outside of Canada and that the permitted client may experience difficulty in enforcing legal rights against the IFM as a result of the location of the IFM and its assets; and the name and address of the IFM's agent for service of process in the local jurisdiction.

Initial and Ongoing Filing Requirements

In order to claim the exemption, the IFM must file a completed Form 32-102F2 – Notice of Regulatory Action – with the applicable securities regulator in the Relevant Jurisdiction within 10 days of first relying upon the exemption, explained Sadler. Any change to information previously reported to the regulator on that form must be provided within 10 days of the change.

"Finally, IFMs that avail themselves of the permitted client exemption have an annual filing obligation, due by December 1 of each year, disclosing the fact that the IFM relied upon this exemption and the total assets under management owned by residents in the applicable Relevant Jurisdiction," Sadler explained.

Dealer Registration

What Constitutes Being in the Business of Trading Securities?

Generally speaking, when it comes to regulating broker-dealer activity, Canadian regulations require a person that engages "in the business" of trading securities in Canada to register as a dealer or rely upon an appropriate exemption from registration.

The concept of trading is broadly defined under Canadian law to include not only the sale or disposition of a security, but also "any act, solicitation or conduct that is directly or indirectly in furtherance of the sale or disposition of a security," explained Sadler. Unlike the IFM registration requirement, the business trigger for dealer registration has been harmonized across the various provinces and territories, although it should be noted that regulators may enforce the rules differently.

Determining what level of activity rises to the level of being in the business of trading securities is not always a straightforward analysis. Based on guidance issued by the Canadian regulators, advisers that have light touch points into Canada – for example, foreign advisers that market their hedge funds only to a very limited number of large Canadian institutional investors on an infrequent basis and do not pay commissions to their sales team or expect to earn a profit from trading in securities – are arguably not in the business of trading securities, explained Elliott.

Other practitioners take an alternative view on what it means to be in the business of trading securities. Dealing directly with prospective fund investors – such as when a manager speaks with an investor to discuss the merits of investing in its fund or delivers fund offering documents – is generally viewed as an act in furtherance of a trade and therefore constitutes dealer activity triggering dealer registration, Thiele explained.

Once the registration requirement is triggered, the manager must register as a dealer; rely upon an available exemption; or engage a third-party dealer to facilitate the transaction.

Advisers should also consider if initial meetings are likely to focus on an introduction to the adviser entity, such as the types of investment services that it can provide to the client, a background on the portfolio managers, a description of the manager's investment style and its general approach to portfolio construction, observed Thiele. There is a strong argument that these sorts of high-level discussions do not give rise to dealer activity, as the fund is not being marketed by the adviser. Any documents used at the meeting or distributed to attendees, of course, would need to support the notion that the meeting focused on the investment adviser entity and investment mandate, noted Thiele; any mention of a fund's investment terms or prior performance, therefore, may be problematic.

Additionally, while there is no reverse solicitation exemption from the dealer registration requirement, it would certainly be relevant to whether the business trigger is engaged, noted Sadler. Finally, conversations that center on setting up a managed account for the client would not trigger dealer registration, as the launch of a managed account is not a sale of a security.

International Dealer Exemption

For advisers that conclude that their touch points into Canada are likely to constitute dealer activity, the next step is to determine if there is an available exemption on which to rely. One exemption that may be available is the "international dealer exemption" (IDE).

The IDE, however, is premised on the concept of substituted compliance, which means that an entity can only rely upon this exemption if it is registered as a dealer in its home jurisdiction. This is a significant impediment to most U.S. hedge fund managers seeking to rely upon this exemption, as they tend not to be registered with the SEC as broker-dealers, explained Sadler. Notably, the fact that an entity is eligible for an exemption from registration as a dealer in the entity's home jurisdiction would not permit the entity to rely upon the IDE exemption.

For more on broker-dealer registration concerns for U.S. advisers, see "SEC Settlement Order Reignites Concerns Over Whether Private Fund Managers Must Register As Brokers" (Jun. 6, 2016); and "Do In-House Marketing Activities and Investment Banking Services Performed by Private Fund Managers Require Broker Registration?" (Apr. 18, 2013).

In order to rely upon the IDE, the dealer is restricted to soliciting permitted clients. Perfecting the exemption is fairly easy and requires that the dealer entity comply with the following terms and conditions, noted Sadler:

- be formed outside of Canada, with its head office and its principal place of business outside of Canada;
- be registered to carry on the activities of a dealer, and engage in the business of a dealer, in the foreign jurisdiction where its head office or principal place of business is located;
- trade as principal or agent for the issuer of the securities; a permitted client; or a person or company that is not a resident of Canada;
- submit a completed Form 31-103F2 – Submission to Jurisdiction and Appointment of Agent for Services – to the securities regulatory authority; and
- provide certain disclosures in writing to permitted clients, including that it is not registered in the local jurisdiction to trade in securities; the location of the entity's head office or principal place of business; the fact that all or substantially all of the assets of the entity may be outside of Canada; the fact that the permitted client may experience difficulty in enforcing legal rights against the entity as a result of the location of the entity and its assets; and the name and address of its agent for service of process in the local jurisdiction.

Entities that claim the IDE are required to file an annual notice each year no later than December 1 with the applicable securities regulator notifying them of their continued reliance upon the exemption.

Engaging a Third-Party Broker-Dealer

For U.S. managers that are engaged in dealer activity but cannot rely upon the IDE, the remaining option is for them to engage a third-party broker-dealer to facilitate the sale of their fund securities. The dealers that are typically engaged to provide this service are registered in Canada as "exempt market dealers" (EMDs), which are authorized to deal in the private placement market.

EMDs are typically engaged through the execution of a dealer placement agreement and are often paid an annual fee, plus a commission for each trade that is facilitated, subject to a cap. In these circumstances, Sadler explained that he would expect the EMD to provide fairly traditional private placement agency services, which involve facilitating communications between the investor and the manager, delivering offering and disclosure materials to the investor and accompanying the manager to meetings with prospective investors.

While engaging an EMD is not a difficult process and the fees are fairly minimal when weighed against the sizeable investments that they may help to facilitate, some U.S. hedge fund managers feel that they are handcuffed by this approach and do not want to be chaperoned by an EMD at meetings with prospective investors. They would prefer the EMD's role to be solely administrative in nature, such as delivering the fund's subscription agreement to investors. The challenge for the EMD, however, is that it has its own obligations under the securities laws to fulfill; accordingly, an EMD may not be comfortable being looped into the process at the end in light of their own regulatory obligations.

---

[1] Permitted clients are defined within National Instrument 31-103 to include any of the following:

(a) a Canadian financial institution or a Schedule III bank;

(b) the Business Development Bank of Canada incorporated under the Business Development Bank of Canada Act;

(c) a subsidiary of any person or company referred to in paragraph (a) or (b), if the person or company owns all of the voting securities of the subsidiary, except the voting securities required by law to be owned by directors of the subsidiary;

(d) a person or company registered under the securities legislation of a jurisdiction of Canada as an adviser, investment dealer, mutual fund dealer or exempt market dealer;

(e) a pension fund that is regulated by either the federal Office of the Superintendent of Financial Institutions or a pension commission or similar regulatory authority of a jurisdiction of Canada or a wholly owned subsidiary of such a pension fund;

(f) an entity organized in a foreign jurisdiction that is analogous to any of the entities referred to in paragraphs (a) to (e);

(g) the Government of Canada or a jurisdiction of Canada, or any Crown corporation, agency or wholly owned entity of the Government of Canada or a jurisdiction of Canada;

(h) any national, federal, state, provincial, territorial or municipal government of or in any foreign jurisdiction, or any agency of that government;

(i) a municipality, public board or commission in Canada and a metropolitan community, school board, the Comité de gestion de la taxe scolaire de l'île de Montréal or an intermunicipal management board in Québec;

(j) a trust company or trust corporation registered or authorized to carry on business under the Trust and Loan Companies Act (Canada) or under comparable legislation in a jurisdiction of

Canada or a foreign jurisdiction, acting on behalf of a managed account managed by the trust company or trust corporation, as the case may be;

(k) a person or company acting on behalf of a managed account managed by the person or company, if the person or company is registered or authorized to carry on business as an adviser or the equivalent under the securities legislation of a jurisdiction of Canada or a foreign jurisdiction;

(l) an investment fund if one or both of the following apply: (i) the fund is managed by a person or company registered as an investment fund manager under the securities legislation of a jurisdiction of Canada; and/or (ii) the fund is advised by a person or company authorized to act as an adviser under the securities legislation of a jurisdiction of Canada;

(m) in respect of a dealer, a registered charity under the Income Tax Act (Canada) that obtains advice on the securities to be traded from an eligibility adviser, as defined in section 1.1 of National Instrument 45-106 Prospectus and Registration Exemptions, or an adviser registered under the securities legislation of the jurisdiction of the registered charity;

(n) in respect of an adviser, a registered charity under the Income Tax Act (Canada) that is advised by an eligibility adviser, as defined in section 1.1 of National Instrument 45-106 Prospectus and Registration Exemptions, or an adviser registered under the securities legislation of the jurisdiction of the registered charity;

(o) an individual who beneficially owns financial assets, as defined in section 1.1 of National Instrument 45-106 Prospectus and Registration Exemptions, having an aggregate realizable value that, before taxes but net of any related liabilities, exceeds CAD$5 million;

(p) a person or company that is entirely owned by an individual or individuals referred to in paragraph (o), who holds the beneficial ownership interest in the person or company directly or through a trust, the trustee of which is a trust company or trust corporation registered or authorized to carry on business under the Trust and Loan Companies Act (Canada) or under comparable legislation in a jurisdiction of Canada or a foreign jurisdiction;

(q) a person or company, other than an individual or an investment fund, that has net assets of at least CAD$25 million as shown on its most recently prepared financial statements; and

(r) a person or company that distributes securities of its own issue in Canada only to persons or companies referred to in paragraphs (a) to (q).

This material has been printed by and is for their consumption only. The full Terms of Use are available at www.hflawreport.com.
UNAUTHORIZED USE OR DISTRIBUTION IS UNLAWFUL