

Canada

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1. MARKET OVERVIEW

There are a number of collective investment vehicles in Canada that fall under the umbrella of ‘investment funds’. The two groupings are: (i) open-ended mutual funds; and (ii) non-redeemable investment funds or closed-ended funds. Mutual funds generally issue an unlimited number of securities on a continuous basis and provide a regular redemption feature, typically daily, at the fund’s net asset value (NAV). Mutual funds are generally, although not exclusively, retail products. By contrast, non-redeemable investment funds typically issue a finite number of securities by private placement or on an initial public offering, following which, in the latter case, the securities are generally traded on an exchange at prevailing market prices, independent of the fund’s NAV. As with mutual funds, non-redeemable investment funds are offered both in the public sphere to retail investors (which requires the use of a prospectus) and privately on a prospectus-exempt basis to ‘sophisticated’ investors.

Among mutual funds are not only traditional retail mutual funds but also exchange-traded mutual funds (ETFs), the securities of which trade on a stock exchange. With ETFs, typically only large institutional investors – so-called designated brokers – purchase or redeem ETF securities directly from the fund at the fund’s NAV, and then only in large blocks, which are usually exchanged in-kind with baskets of the underlying securities. Individual retail investors typically buy and sell units of ETFs on the exchange at prevailing market prices, which may be at a premium or discount to a fund’s NAV.

Mutual funds rose in popularity primarily due to changes to the Income Tax Act (Canada) (Tax Act) in the late 1950s, which enabled them to flourish as vehicles for registered retirement savings plans for Canadians. As noted by the Canadian Securities Administrators (CSA) in Staff Notice 81-322, by the late 1960s, assets under management by mutual funds in Canada had considerably surpassed those under management by non-redeemable investment funds, which prior to that time had been the most prevalent form of publicly offered investment fund. The Investment Funds Institute of Canada (IFIC), whose members manage approximately 85 per cent of mutual fund assets in Canada, states that in 1982 the Canadian mutual fund industry had approximately 578,000 fund accounts with C\$4.1 billion of assets under management. As at April 2011, this had grown to approximately 45 million accounts with C\$665 billion in assets under management.

ETFs have also flourished, with assets under management growing

from approximately C\$6 billion in December 2000 to approximately C\$41 billion as at March 2011. The Canadian market for private non-redeemable investment funds such as hedge funds has also continued to expand in recent years. As recently as 1999, the Canadian market was made up of fewer than 50 hedge funds with roughly C\$2.5 billion in assets under management (*Hedge Fund Industry in Canada*, 2005, Alternative Investment Management Association (AIMA)). By January 2011, the market was reported to have grown to approximately 190 hedge funds and hedge fund-related products with between C\$35 and C\$40 billion in assets under management.

2. PRIVATE FUNDS – CLOSED-ENDED

Private non-redeemable investment funds or closed-ended funds (private funds), including hedge funds structured as such, are investment funds that are sold in Canada by way of private placement, meaning that in contrast to retail offerings which are sold by way of prospectus, they are sold on the basis of a prospectus exemption. The prospectus exemption most commonly used to place private fund securities in Canada is the ‘accredited investor’ exemption, which permits the distribution of a security to a purchaser without a prospectus where the purchaser purchases as principal and is an accredited investor. The definition of ‘accredited investor’ in National Instrument 45-106 – Prospectus Exempt Distributions – of the CSA (NI 45-106) includes institutional investors and high net worth individuals.

2.1 Common structures

There is no prescribed structure for a private fund in Canada. Private funds can be found organised as corporations, trusts or limited partnerships. The choice of structure is usually determined by the investor and investment profiles of the private fund and their related tax objectives.

Corporations

A private fund may be organised as a corporation under either the Canadian federal business corporation statute or the corresponding statutes of any one of the provinces or territories; the statutes are generally similar. A private fund that is a corporation can utilise a multiple class structure, with each class of shares tracking a different portfolio of assets. Tax-deferred switches between classes are available.

Trusts

Many private funds in Canada are structured as ‘mutual fund trusts’, which are flow-through vehicles generally taxed at the highest marginal rate for individuals. However, a deduction is available in respect of income paid or payable to beneficiaries, making trusts generally efficient flow-through vehicles for investment income. To the extent that the trust may deduct expenses or losses, it may not allocate losses to unit holders.

A private fund structured as a mutual fund trust is managed by an administrative arm, the trustee, which is independent from the beneficiaries. The management of the trust is subject to the rules applicable to the

administration of the property of others. As it is the case with respect to the directors of corporations, the trustees of a trust also have the power to name the officers of the trust.

Limited partnerships

A limited partnership is not a legal entity separate from its partners under Canadian law, meaning that the gains and losses of the fund flow through to its limited partners. That said, limited partnerships are typically treated as separate legal entities. For example, a limited partner may lend money to, and transact business with, the limited partnership. A limited partnership is required to have a general partner and at least one limited partner. A limited partner is not liable as a general partner unless, in addition to exercising rights and powers as a limited partner, the limited partner takes part in the control of the business. Unlike the limited partnership legislation in some jurisdictions, the limited partnership statutes in Canada do not contain 'safe harbour' provisions clearly delineating conduct that is not taking part in the control of the business of the partnership. Consequently, limited partnership agreements need to be drafted with particular care surrounding this issue.

2.2 Regulatory framework

There are no specific rules that apply to private funds sold on a private placement basis that regulate their investment activities or how they operate.

Securities legislation in Canada is under the jurisdiction of the 10 provinces and three territories, each with its own laws, rules and policies. However, the regulation of investment funds and the distribution of securities have for the most part been harmonised across the country in the form of National Instruments. The offer and sale of investment funds in Canada must be made in compliance with the rules applicable in each jurisdiction. For the purposes of this analysis, any references to securities laws will refer to the Securities Act (Ontario) (OSA), however, specific provincial and territorial securities acts should be consulted as appropriate.

Prospectus exemption

Private funds typically raise money under one of the prospectus exemptions available under NI 45-106. The most frequently used among the capital-raising exemptions is the accredited investor exemption. This prospectus exemption is available in respect of sales of securities to a list of qualified entities and individuals. Included among the qualified entities are certain types of banks and other financial institutions, trust companies, pension funds, registered charities, investment funds, domestic and international governmental bodies and entities other than individuals or investment funds with net assets of C\$5 million. An individual may also qualify as an accredited investor if they, alone or with a spouse, own financial assets having an aggregate net realisable value over C\$1 million; have net assets of at least C\$5 million; or have net income before taxes in excess of C\$200,000 alone, or C\$300,000 together with their spouse.

To offer a security by way of a prospectus exemption does not require that a written document describing the business and affairs of an issuer be provided to prospective purchasers. However, if any written document is provided it may constitute an 'offering memorandum' under the securities legislation of some provinces in Canada. An offering memorandum distributed in Ontario, for example, is required to include certain prescribed disclosure. This includes disclosure relating to statutory rights of action for damages or rescission that are available to purchasers where the offering memorandum contains a misrepresentation, as well as disclosure relating to certain conflicts of interest.

Securities purchased pursuant to a prospectus exemption are also subject to resale restrictions or 'hold periods'. For a private fund with securities that are never listed on a Canadian stock exchange, this effectively means that its securities will never be freely tradeable. However, such securities can be traded or transferred pursuant to a further prospectus exemption (ie, to another accredited investor). In addition, when securities are issued from treasury pursuant to a private placement exemption, the issuer is required to file a report of trade (and pay a fee) with the securities regulators in each Canadian jurisdiction in which the securities are sold within 10 days of the distribution.

Registration

There are three types of registration that are relevant to private funds (and, it should be stressed, investment funds generally). Persons or companies involved in the offering of investment fund securities to investors in Canada, the provision of portfolio management services to investment funds, and the management of investment funds are all subject to regulation.

The registration regime in Canada, which was overhauled in September 2009, requires that a person or company engaging in or holding itself out as engaging in the business of selling securities as principal or agent be registered as a dealer, that a person or company engaging in or holding itself out as engaging in the business of advising others as to the investing in or the buying or selling of securities be registered as an adviser and that a person or company that directs the business, operations or affairs of an investment fund be registered as an investment fund adviser. The key rule under the registration regime is National Instrument 31-103 – Registration Requirements, Exemptions and Ongoing Registrant Obligations (NI 31-103), which sets out the categories of registration; the proficiency, capital, insurance and other basic requirements for registration; the ongoing requirements regarding internal controls and systems; financial conditions; and reporting, dealing with clients and handling client accounts.

A person in the business of trading in securities as principal or agent is required to be registered as a dealer in the provinces or territories in Canada where it is trading. There are limited exemptions. Issuers such as private funds could be caught by this requirement, but the matter is very fact specific. NI 31-103 includes a dealer registration exemption for trades by a person or company if the trade is made solely through an agent who is a registered dealer, if the dealer is registered in a category that permits the trade. In the

companion policy to NI 31-103, which sets out guidance on how the CSA interpret or apply the provisions of NI 31-103, it is noted that this exemption is available when no intermediary is involved in a trade, for example, when an individual or firm trades their own securities directly with a registered dealer and that an individual or firm will have to register if they trade another party's securities with a third party. A fund that hires an appropriately registered dealer to distribute its securities should have the benefit of this exemption. A fund sponsor involved in placement activity would not appear to fall within the terms of the exemption and would appear to require registration as a dealer to sell the fund's securities directly.

A person or company providing portfolio management services for, or other investment advice to, a private fund would need to be registered as an adviser in the Canadian jurisdiction where the fund is receiving the advice, which would typically be where the fund is managed in Canada.

The registration regime includes the requirement that a person directing the business, operations or affairs of a fund be registered as an investment fund manager. This would include the manager of a private fund.

2.3 Operational requirements

Save for any ongoing requirements applicable in respect of dealer, adviser or investment fund manager registration as noted in section 2.2, there are generally no other ongoing filing or consent requirements prescribed by the securities legislation in Canada for privately placed private funds.

2.4 Marketing the fund

Subject to limited exceptions, there are general restrictions on the advertising and marketing of securities in Canada. For instance, securities legislation generally prohibits the promotion of privately offered investments in securities on radio or television.

Please also see the discussion in section 2.1 dealing with the prospectus exemption and registration requirements, which inform the manner in which securities of a private fund may be marketed.

2.5 Taxation

The tax treatment of a private fund in Canada is primarily determined by its characterisation as a partnership, mutual fund trust or mutual fund corporation (note that the use of the term 'mutual fund' in these instances designates a term of art under the Tax Act and is not meant to delineate between investment funds structured as open-ended mutual funds and entities structured as non-redeemable investment funds). Several of the specific differences between the taxation of these vehicles are discussed in more detail below.

Limited partnerships

A limited partnership itself is generally not liable for income tax nor is it required to file income tax returns, except in some cases for annual information returns. A partnership must compute its income (or loss) under

the Tax Act for each of its fiscal periods as if it were a separate person resident in Canada. As a partnership, all income, capital gains, losses and capital losses of the private fund would flow through to its investors. However, a specified investment flow-through partnership is effectively taxed as a corporation on its non-portfolio income (see the discussion regarding the specified investment flow through (SIFT) rules below).

Subject to the 'at-risk' rules discussed below, each partner of a partnership will be required to include (or be entitled to deduct) (whether or not distributions have been made by the partnership), when computing the partner's Canadian income for a taxation year, the partner's *pro rata* share of the income (or loss) of the partnership allocated to them for the fiscal period of the partnership ending in or at the end of the partner's taxation year. The Tax Act contains at-risk rules that may, in certain circumstances, limit the amount of deductions that a limited partner may claim in respect of a partnership to the amount the partner has put at risk.

A disposition of an investment in a Canadian limited partnership, a mutual fund trust, or a share of a mutual fund corporation (as described below) by a non-resident of Canada for purposes of the Tax Act will generally not be subject to Canadian tax unless the investment is 'taxable Canadian property' for purposes of the Tax Act and the gain is not exempt from Canadian tax by an applicable income tax treaty or convention.

Generally, limited partnership interests, units of mutual fund trusts or shares of mutual fund corporations will not be taxable Canadian property at any time, unless at any time within the five previous years more than half of the fair market value of the partnership's property was attributable to real or immovable property in Canada or certain Canadian resource properties.

A disposition of limited partnership interests, mutual fund trust units or shares of mutual fund corporations by a Canadian resident investor who holds the investment as capital property will generally result in a capital gain (or loss) to that investor.

Trusts

A private fund structured as a mutual fund trust will generally not be liable for income tax in respect of its income and net realised capital gains for a taxation year to the extent that it distributes the income and net realised capital gains to its beneficiaries. To qualify, a mutual fund trust must meet certain conditions, including those relating to the number of its unit holders.

Provided that certain conditions are met, a mutual fund trust may designate a portion of its foreign source income to its unit holders so that such income and a portion of the foreign tax paid by the trust may be regarded as foreign source income of, and foreign tax paid by, the unit holder for the purposes of the foreign tax credit provisions of the Tax Act. Generally, when a mutual fund trust designates certain amounts to its unit holders, including, but not limited to, dividends received and foreign source income, these designated amounts will retain their character in the hands of its unit holders.

The Tax Act treats 'non-portfolio income' of a SIFT trust or partnership as if the income had been earned through a taxable Canadian corporation. Under

the SIFT rules, tax is imposed at the trust or partnership level at the corporate tax rates and investors are deemed to have received dividends from taxable Canadian corporations. Income that is subject to this tax is generally income from carrying on a business in Canada, Canadian real or immovable property or investments in subject entities in excess of certain thresholds.

Investors in a mutual fund trust are required to include in their income for tax purposes the amount of net income and net realised taxable capital gains paid or payable to them by the trust and deducted by the trust in computing its income for tax purposes. Generally, to the extent that distributions to an investor by the trust exceed the investor's share of the net income and net realised capital gains of the trust for the year, such excess distributions (except to the extent that they are proceeds of the disposition of a unit) will not be taxable in the hands of the investor but will reduce the adjusted cost base of an investor's units of the trust. To the extent that the adjusted cost base of a unit will be negative, the negative amount will be deemed to be a capital gain realised by the investor in the year, and the adjusted cost base of the unit will be increased by the amount of the deemed capital gain.

See the discussion under 'limited partnerships' above for the general Canadian tax consequences of an investor disposing of a mutual fund trust unit.

Corporations

A corporation is a single legal entity for tax purposes. Corporations are generally not an efficient vehicle for the flow-through of ordinary income. However, a mutual fund corporation is tax-efficient with respect to taxable dividends earned on shares of taxable Canadian corporations because it is able to deduct those dividends from its income and receive a refund of tax that it pays on those dividends upon paying taxable dividends out to its shareholders. Also, taxes paid by the mutual fund corporation on realised capital gains will be refundable on a formula basis when shares are redeemed or when the fund pays capital gains dividends. As a result, capital gains dividends are taxed as capital gains in the hands of the shareholders. To qualify as a mutual fund corporation, a corporation must meet certain prescribed conditions.

Taxable dividends and/or eligible dividends paid by a corporate fund, other than capital gains dividends, must be included in computing an investor's income. The dividend gross-up and tax credit treatment normally applicable to taxable dividends and eligible dividends paid by a taxable Canadian corporation will apply to such dividends in the case of an investor who is an individual. Returns of capital distributions are not included in income but reduce the adjusted cost base of the investor's shares.

See the above discussion under 'limited partnerships' for the general Canadian tax consequences of an investor disposing of shares of a mutual fund corporation.

2.6 Customary or common terms

The characteristics of a private fund largely depend on its particular mandate – the private nature of these funds generally means that there are few

regulatory restrictions. The typical difference between a private fund, such as a hedge fund, and other investment funds is that private funds generally have very broad investment mandates with few restrictions. Unlike mutual funds, they are permitted to use techniques such as leverage and short selling and often use derivative instruments.

The compensation of a private fund's manager often includes a share of the investment returns in the form of performance fees. These fee arrangements are often structured so that the manager is entitled to additional incentive management fees based on higher returns.

3. HEDGE FUNDS

As a hedge fund in Canada is in form and substance typically no different from a private non-redeemable investment fund or closed-ended fund, please refer to the discussion in section 2.

4. RETAIL FUNDS

4.1 Common structures

Retail investment funds in Canada are typically of three varieties: traditional mutual funds, ETFs and non-redeemable investment funds or closed-ended funds. The vast majority of these retail funds are structured as trusts.

4.2 Regulatory framework

Traditional mutual funds and ETFs are typically offered by prospectus to retail investors and are governed by a number of specific rules that prescribe particular prospectus disclosure and set out, among other things, requirements concerning the investments that they are permitted to make, restrictions on leverage and various investment practices and custody. Non-redeemable investment funds offered by prospectus are subject to the general prospectus rule applicable to all types of issuers and are subject to requirements on custody, but not other specific rules governing permitted investments. All investment funds that are 'reporting issuers' (their status resulting from their offering by prospectus to the retail market or being listed on an exchange in Canada) are subject to rules concerning continuous disclosure and requirements for an independent review committee, being National Instrument 81-106 – Investment Fund Continuous Disclosure (NI 81-106) and National Instrument 81-107 - Independent Review Committee for Investment Funds (NI 81-107). In addition, open-ended mutual funds are regulated under National Instrument 81-102 – Mutual Funds, which provides a comprehensive set of rules governing such things as investment restrictions, conflict of interest/self-dealing rules, security holder approval requirements, custodianship of portfolio assets and permitted sales practices. Mutual funds are typically prohibited from using leverage, however, in the past several years the CSA has been granting certain exemptions to permit mutual funds to utilise leverage.

As noted in section 2.2, there are portfolio manager and fund manager registration requirements that are applicable to all investment funds in Canada.

4.3 Operational requirements

As noted previously, the continuous disclosure requirements of NI 81-106 apply to all investment funds that are reporting issuers. NI 81-106 requires annual financial statements to be filed with the securities commissions in Canada, mailed to investors and made electronically available on the internet at the CSA's public disclosure website (www.sedar.com) and on the fund's website within 90 days of the fund's financial year end. The same statements are required to be filed and mailed to investors on an interim basis, within 60 days of the end of the interim period. All financial statements must be approved by the fund's trustees (or board of directors, if the fund is a corporation).

Under NI 81-106, investment funds that are reporting issuers are also required to file and mail to investors 'management reports of fund performance' (MRFP) on an annual and interim basis. The MRFP requires approval from the board of trustees (or equivalent) of the fund and it must be prepared in accordance with the specific requirements of NI 81-106. The annual and interim MRFPs are required to contain: management's discussion of fund performance including results of operation, recent developments and related party transactions; financial highlights; past performance; a summary of investment performance; and other material information. The annual MRFP must include additional topics such as fund objectives or strategies and risks, and requires the presentation of year-by-year returns and annual compound returns.

An investment fund that has not obtained receipt for a prospectus during the last 12 months preceding its financial year end must also file an 'annual information form' (AIF) within 90 days of the financial year end. The content of an AIF includes a description of the investment fund's investment objectives and restrictions, portfolio valuation methodologies, NAV calculation methodologies and relevant tax disclosure.

NI 81-107 requires every investment fund that is a reporting issuer to have a fully independent body – an independent review committee (IRC) – which is responsible for overseeing decisions that pose or have the potential to pose a conflict of interest: matters where a reasonable person would consider a fund manager to have an interest that may conflict with the manager's ability to act in good faith and in the best interests of the fund. NI 81-107 also sets out a standard of care for investment fund managers with a view to ensuring that the interests of the investment fund are paramount when a fund manager is faced with a conflict of interest.

4.4 Marketing the fund

The offer and sale of investment funds on a retail basis in Canada must be done using a prospectus. For non-redeemable investment funds, the prospectus offering procedure is the same as with any other issuer, which, in short, requires that a preliminary prospectus be filed with the securities commissions in the Canadian provinces and territories in which the securities are to be offered for their review and comment. Marketing – by registered dealers only – is typically done using the preliminary prospectus. Following

review by the securities commissions, a final prospectus is filed and sent to all prospective purchasers who received the preliminary prospectus with closing typically occurring within a few days. The content of the prospectus is dictated by form requirements, the objective of which is to ensure that purchasers are in possession of all material information regarding the issuer and the securities on offer.

The offering regime for mutual funds is based on the same principles, but the form of offering documents is somewhat different. For mutual funds, there are three primary offering documents: a 'simplified prospectus', an AIF and a 'fund facts' document. The simplified prospectus has a basic education component outlining the fundamental workings of a mutual fund and introducing information about the particular mutual fund. It is required to be drafted in plain language. An AIF is required to be concurrently filed with the prospectus. The AIF is incorporated by reference into the simplified prospectus, as are financial statements and the most recent annual and interim management reports of fund performance. Only the simplified prospectus itself need be delivered to prospective investors.

As of 2011, mutual funds are required to deliver a simple and concise fund facts document to investors before or at the point of sale, consisting of a summary setting out the details of the mutual fund. The fund facts document also contains an explanation of how to obtain more information about the mutual fund, including a foundation document and the mutual fund's continuous disclosure record.

Mutual funds are required to be sold by registered dealers who are also members of the self-regulatory organisation called the Mutual Fund Dealers Association of Canada (MFDA). There are comprehensive rules governing sales practices that may be employed in the marketing of mutual funds. These rules are set out in National Instrument 81-105 – Mutual Fund Sales Practices as well as in guidelines established by the MFDA.

4.5 Taxation

Please refer to the discussion in section 2.5.

4.6 Customary or common terms

A mutual fund is generally open-ended with no fixed termination date. The fund is typically terminated on the actions of its manager rather than by security holders, although a security holder vote may be required in certain circumstances. ETFs on the other hand typically exist for a specified period of time. In addition, a mutual fund is redeemable on demand by a security holder at any time at the NAV of the fund whereas ETFs gain their liquidity through the facilities of the stock exchange where the units or shares trade freely. Periodically, there may be the ability for investors to redeem directly from the ETF; however, the redemption value is based on a formula that is not necessarily the NAV of the fund.

In retail mutual funds, the only requirement for the manager to make an investment in the fund is upon creation. New mutual funds must have C\$150,000 deposited in the fund prior to any distributions to the public. This

amount may be redeemed once certain conditions are met. There is no such requirement for ETFs.

Managers are typically paid a fee calculated as a percentage of the NAV. ETF managers will generally be paid a monthly fee based on the NAV although there could be performance fees associated with certain levels of fund performance.

A mutual fund typically cannot borrow cash or provide a security interest over any of its portfolio assets except in specific circumstances, such as: (i) when it is a temporary measure to accommodate requests for the redemption of securities of the mutual fund provided the value does not exceed 5 per cent of the net assets of the mutual fund; (ii) if the security interest is required to enable the mutual fund to effect a specified derivative transaction; or (iii) the security interest secures a claim for the fees and expenses of the custodian or a sub-custodian of the mutual fund for services rendered in that capacity.

5. PROPOSED CHANGES AND DEVELOPMENTS

The CSA have begun work on a 'modernisation project' focused on retail mutual funds and ETFs with the objective of identifying and addressing any market efficiency, investor protection or fairness issues that arise out of the differing regulatory regimes that apply to different types of publicly offered investment funds. One of the goals is to codify frequently granted exemptive relief that accounts for market and product developments, particularly ETFs. The CSA note that while the structure and operations of mutual funds and non-redeemable investment funds may vary, both types of funds offer investors the benefits of pooled investing and portfolio management services. As a result, the CSA are considering adopting for non-redeemable investment funds certain core restrictions and operational requirements analogous to those in NI 81-102 for mutual funds, including: measures to protect investors from transactions that give rise to a conflict of interest; providing investors with the opportunity to vote on important changes that may impact the investment fund and its investors; ensuring the proper safeguarding of the investment fund's assets; and, potentially, some core investment restrictions. The CSA anticipate that a proposed new rule will be published for comment in early 2012.

The CSA also propose to re-examine the investment restrictions applicable to open-ended mutual funds and ETFs under NI 81-102 to assess if any changes should be made in recognition of market and product developments. For example, the CSA will consider whether it would be beneficial to investors if certain investment restrictions in NI 81-102 were loosened, such as investments in physical commodities and new derivatives strategies, in order to achieve a more fair and consistent regulatory framework across all investment fund products. The CSA will also consider whether additional investment restrictions are needed to further reduce product and market risks and to ensure a mutual fund's ability to satisfy redemptions on demand.

