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# Investment Funds

Canada  
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## Law and Practice

Contributed by Fasken

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**Fasken** has an investment funds practice group comprised of 22 partners and six non-partners, based in Toronto and Montreal offices. Fasken's investment funds practice is best known for the following: innovative and complex investment fund structures; persistent advocacy for clients in respect of novel exemptive relief based on technical knowledge of applicable laws and deep understanding of industry practices (for example, establishing the precedents for much of the exemptive relief now routinely obtained by Canadian ETFs); a variety of long-standing clients including managers of mutual funds, ETFs, private equity and closed-end funds; employing leading experts in specialised

fields who support the investment funds practice; leadership in the development of the investment fund governance regime in Canada; and advising issuers, managers, distributors, financial institutions and service providers on the full range of investment products and services available in the country. Fasken's investment fund practice also is very strong in mergers & acquisitions within this industry. The firm's expertise covers all critical aspects of these transactions including: deal structure and process, due diligence, negotiations, regulatory approvals and post-closing integration.

## Authors



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**Garth Foster** is a partner at the firm. He is extensively involved in the investment funds, registration and securities law areas. He actively advises a number of public and private investment funds including exchange traded funds. Garth

has created new funds, including hedge funds, drafted trust, management, advisory, sub-advisory and distribution agreements, filed numerous applications for exemptive relief and prepared offering documents for both public and private funds. He has also been involved in a number of mutual fund acquisitions and reorganisations. In addition, Garth has registered, and provides ongoing compliance and registration advice to various advisers, dealers and investment fund managers. He also comments on policy initiatives in the investment funds, registration and securities law areas.



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François has developed a business law practice with a focus on serving the investment management industry.

Combining his business training with his legal practice, François proposes

innovative solutions to clients' challenges in an ever-changing competitive and heavily-regulated landscape. He regularly advises asset and fund managers in connection with the establishment, offering and administration of several investment funds, whether retail conventional or alternative mutual funds, pooled funds or hedge funds, investing in all types of asset classes, traditional and alternative, such as infrastructure, private equity, private lending, real estate and cryptocurrency. His understanding of the investment management industry has also led several investment management businesses to seek his advice in connection with their acquisitions, joint ventures or when auctioning themselves off to the highest bidder, helping clients at all stages of the process, from the initial deal structuring to the post-closing integration of assets. He is a member of the Board of Governors of the Conseil des fonds d'investissement du Québec, the Québec arm of the Investment Funds Institute of Canada, and member of various committees thereof.



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## 1. Fund Formation

### 1.1 Formation of Investment Funds

The Canadian investment funds industry is relatively mature. The range of investment funds is broad and includes:

- public mutual funds and exchange traded funds for retail investors;
- alternative investment funds and structured products for more sophisticated investors; and
- private pooled funds used for focused purposes.

It should be noted that funds that are non-passive investors (such as private equity funds) or that carry on a business activity, (such as lending or real estate ownership) are not 'investment funds' under Canadian securities legislation and are therefore not discussed in this guide.

### 1.2 Raising Capital from Investors

Canadian investment funds are used primarily for raising capital domestically due to Canadian withholding taxes that apply to distributions paid to non-resident investors. Generally, a non-Canadian firm will establish an investment fund in Canada only if the firm is targeting non-institutional clients in Canada. This is because forming an investment fund in Canada typically triggers a requirement for its manager to become registered in one or more capacities with the Canadian securities administrator in the province or territory where the investment fund is formed.

### 1.3 Common Process for Setting Up Investment Funds

An investment fund formed in Canada generally is structured as either a trust, a corporation or a limited partnership. The reason for selecting one structure over another is based mainly on the Canadian tax treatment of the fund and its investors.

#### Funds Formed as a Trust

The most common structure for a Canadian investment fund is a trust formed by executing either a unilateral declaration of trust, (where the manager acts as the fund's trustee) or a bilateral trust agreement (where the manager retains a licensed trust company to act as the fund's trustee). In this guide, we refer to either of these documents as the 'trust document'. The trust document sets out, among other matters, the powers of the trustee and the rights of investors (referred to as 'unitholders'). Where the trustee is a licensed trust company, the trustee retains the manager to perform all day-to-day activities of the fund, either in the trust document or in a separate management agreement.

#### Funds Formed as a Corporation (or a Class of Shares within a Corporation)

An investment fund can be formed as a corporation by filing articles of incorporation with the relevant Canadian gov-

ernment office. The corporation enters into a management agreement with the manager under which the manager performs all day-to-day activities of the fund, other than those matters that the corporate legislation requires be performed by the corporation's directors.

A corporation also can be used to provide multiple investment funds within that corporation (a 'multi-fund corporation') by having each investment fund represented by its own class of shares.

#### Funds Formed as a Limited Partnership

A limited partnership is formed by filing a declaration with the relevant Canadian government office. A limited partnership agreement is entered into between the general partner and each limited partner that sets out the rights and obligations of the partners, similar to a trust document. The limited partnership, by its general partner, enters into a management agreement with the manager under which the manager performs all day-to-day activities of the fund.

#### Other Material Contracts

Other material contracts entered into by an investment fund vary based on the structure of the fund. However, virtually all investment funds are required by Canadian securities legislation to retain a Canadian custodian to hold the assets of the fund. Fund assets outside of Canada are held by non-Canadian sub-custodians retained by the Canadian custodian. Managers also retain service providers (often related to the custodian) for valuation and investor recordkeeping services. The fund also may have agreements with portfolio management firms to manage some or all of the fund's investment portfolio, as well as agreements with dealers to sell the fund's securities.

### 1.4 Regulation of Fund Structures

There is no requirement that a Canadian investment fund be managed inside of Canada. However, the manager of an investment fund formed in Canada typically is required to register with at least one Canadian securities administrator in one or more capacities, or qualify for exemptions from those requirements.

### 1.5 Limited Liability

Investors in Canadian investment funds generally have the protection of limited liability. There are theoretical circumstances in which an investor may be held liable to the creditors of an investment fund, but such liability has never been asserted and is sufficiently remote that legal opinions confirming the limitation of liability are not requested or given.

The basis for limiting liability varies depending on the structure used. In the case of a fund structured as a trust, legislation has been enacted in most Canadian jurisdictions where funds are formed that confirm the limited liability of unitholders of a trust that is offered to retail investors.

The legislation governing corporations limits the potential liability of shareholders to returning certain unauthorised payments received from the corporation. The legislation governing limited partnerships expressly confirms that limited partners are not liable for the obligations of the limited partnership, unless the limited partner becomes involved in the management of the affairs of the limited partnership (eg, ceases to be a passive partner).

### 1.6 Common Tax Regimes

The Canadian tax regime applicable to an investment fund depends upon its structure. Generally, a fund formed as a trust pays tax on its net income at the rate of approximately 50%, but does not pay income tax provided it distributes its net income annually to its investors. A fund formed as a corporation pays tax on its net income at normal rates applicable to Canadian corporations, but is able to obtain a refund for taxes paid in respect of capital gains and Canadian dividends in certain circumstances. A fund formed as a limited partnership is not subject to Canadian tax and instead allocates its net income annually to its partners.

### 1.7 Investment Sponsors

For the reasons mentioned elsewhere in this guide, non-Canadian firms generally do not form investment funds in Canada unless they are targeting non-institutional clients in Canada.

### 1.8 Disclosure Requirements

If an investment fund makes a public offering of its securities in Canada, it must file with the Canadian securities administrators in each province and territory where it wishes to offer its securities a prospectus containing extensive prescribed disclosure. The prospectus in preliminary form is reviewed and commented upon by the principal regulator and, once acceptable, is refiled in final form and accepted by the principal regulator issuing a 'receipt' for it. At that point, the fund is legally permitted to offer its securities to any investor in Canada without qualification. It then is the responsibility of each investor's dealer to determine whether an investment in the fund is suitable for the client.

A fund which has filed a final prospectus becomes a 'reporting issuer' under Canadian securities legislation, which significantly increases the amount of regulation applicable to the fund's operations, including portfolio management, governance and ongoing disclosure requirements. For this reason, non-Canadian investment funds rarely make public offerings in Canada.

An investment fund need not file a prospectus nor become a reporting issuer in Canada if the fund limits its capital raising activities to a prescribed list of sophisticated investors and circumstances where Canadian securities legislation does not require a prospectus (referred to as 'prospectus-exempt

distributions'). Sophisticated investors (called 'accredited investors') include:

- Canadian financial institutions;
- pension plans;
- accounts that are managed by a registered portfolio manager;
- individuals who, alone or with a spouse, beneficially own financial assets having a realisable value, net of related liabilities, not less than CAD1 million;
- individuals who had net income before taxes not less than CAD200,000 in each of the two previous calendar years or who, together with a spouse, had net income before taxes not less than CAD300,000 in each of the two previous calendar years;
- companies with net assets not less than CAD5 million; and
- other investment funds in Canada.

A prospectus also is not required if the investor is a company that purchases, as principal, not less than CAD150,000 of securities of the investment fund and the company was not created or used solely for the purpose of investing in prospectus-exempt distributions.

A private placement memorandum is referred to in Canadian securities legislation as an 'offering memorandum'. It includes any document describing the investment fund that has been prepared primarily for delivery to prospective investors to assist them with their investment decision, even if the document is not labelled as, or intended to be, a private placement memorandum (such as a PowerPoint presentation). However, it does not include a basic term sheet describing only the terms of the offering.

An offering memorandum generally is not required to make a prospectus-exempt distribution, although certain individual investors are required to sign a prescribed risk acknowledgement form. If an offering memorandum is provided voluntarily to Canadian investors, then it must not contain a 'misrepresentation' as defined in Canadian securities legislation and it must disclose the rights of investors in the event of a misrepresentation. If the fund is non-Canadian and wishes to use in Canada the private placement memorandum it has prepared for use in other jurisdictions, the requirements under Canadian securities legislation usually can be fulfilled by adding a Canadian notice to the document.

An exception to the above is where the investment fund makes a prospectus-exempt distribution by relying on the 'offering memorandum exemption'. In these circumstances, the content of offering memorandum is prescribed and extensive, and the amount that can be raised from individual investors who are not accredited investors is capped.

## 1.9 Legal Forms

Please see **1.3 Common Process for Setting Up Investment Funds**.

## 1.10 Regulatory Status

The status of an investment fund under Canadian securities legislation depends upon three factors:

- whether securities issued by the investment fund are redeemable by investors more frequently than annually for an amount based on their net asset value (called a 'mutual fund' in Canada);
- whether the fund is a 'reporting issuer'; and
- (in some cases) the fund's investment mandate.

### Mutual Funds

Mutual funds are an attractive structure for investors because they provide some assurance of liquidity for the approximate value of their securities. The terms of the redemption rights (such as frequency, notice period, redemption value, payment date, and limits on redemptions) can vary. However, mutual funds that are continuously offered to the public by a prospectus typically provide unlimited daily redemption rights at the net asset value per security, with settlement occurring on the second business day following the redemption (T+2).

There are four variations of mutual funds.

#### *Conventional mutual funds*

Mutual funds that are continuously offered to the public by a prospectus, entitle all investors to redeem their securities on demand for their net asset value per security and do not use any form of leverage in their portfolios are referred to in this guide as 'conventional mutual funds'. Conventional mutual funds are the most highly regulated type of investment fund in Canada, including extensive restrictions on the management of their portfolios.

#### *Exchange-traded funds (ETFs)*

Some mutual funds list their securities for trading on a Canadian stock exchange and only allow large orders for securities (a 'prescribed number of units') to be purchased by dealers from the fund or redeemed at their net asset value. These mutual funds are referred to as 'exchange-traded funds' or ETFs. Since retail investors do not trade in numbers large enough to qualify as a prescribed number of units, they must purchase and sell their securities over the exchange at their prevailing trading price, which may be slightly higher or lower than their net asset value. Select dealers (called 'designated brokers') trade in ETF units over the exchange and in prescribed numbers with the ETF in a manner that helps maintain the trading price of the ETF's units close to their net asset value.

ETFs generally follow a passive investment mandate so that designated brokers can establish hedges for the units they hold in inventory. The passive nature of the fund's mandate and the absence of embedded dealer compensation in the structure result in significantly lower annual expenses for an ETF compared to most conventional mutual funds. In the past ten years, ETFs have grown tremendously in popularity in Canada for this reason.

Some conventional mutual funds also offer one or more classes of securities that trade on an exchange similar to an ETF. This enables the fund to gather assets simultaneously as both a conventional mutual fund and an ETF.

#### *Alternative mutual funds*

Commencing in 2019, some public mutual funds may use leverage in their portfolios and other investment strategies not permitted in conventional mutual funds. These are categorised in Canadian securities legislation as 'alternative mutual funds', and it is not yet known what level of acceptance they will receive among dealers and investors. The prospectus disclosure and regulation of internal operations (other than regulations applicable to the investment portfolio) are similar to conventional mutual funds. Securities of alternative mutual funds can be either listed (like ETFs) or unlisted (like conventional mutual funds).

#### *Pooled funds*

Though not officially designated as such under Canadian securities legislation, 'pooled funds' are mutual funds that are not reporting issuers. Pooled funds have virtually no restrictions imposed on their investment portfolios. Prior to the creation of alternative mutual funds, pooled funds were the vehicle of choice for creating 'hedge funds' and other funds using alternative strategies. Pooled funds are a more flexible and cost-efficient structure for delivering investment strategies to sophisticated investors.

#### **Non-Redeemable Investment Funds**

Investment funds that are not mutual funds are categorised under Canadian securities legislation as 'non-redeemable investment funds' (also called 'closed-end funds'), even though these funds may provide investors with some redemption rights. Due to fewer available redemption rights, non-redeemable investment funds typically are listed on a Canadian stock exchange and the main source of liquidity for investors during most of the year is found by trading their securities over the exchange.

Unlike conventional mutual funds, non-redeemable investment funds are allowed to use alternate investment strategies (including leverage and concentrated portfolio holdings), pay their capital raising expenses (including commissions to dealers) out of their offering proceeds, and issue both common and preferred securities.



During the past few years, non-redeemable investment funds have declined in popularity due to a variety of factors. The greater availability of alternative strategies through alternative mutual funds is likely to further reduce the popularity of non-redeemable investment funds.

### 1.11 Legal, Regulatory or Tax Legislative Changes

On 3 January 2019, Canadian securities legislation was amended to create a new subset of public mutual funds called 'alternative mutual funds'. Alternative mutual funds are permitted to use leverage in their investment portfolios, as well as certain other investment approaches previously available only through non-redeemable investment funds and pooled funds.

The Canadian securities administrators are proposing to increase the standards to be met when sales representatives of dealers make their determinations whether investments are suitable for their clients. If this initiative continues, it may become more difficult to sell investment funds that either use less common investment approaches, or have higher risk ratings.

## 2. Fund Investment

### 2.1 Types of Investors

The range of Canadian investors in investment funds covers the full spectrum from relatively unsophisticated retail investors with little money to invest, to large institutional investors seeking highly specialised portfolio management.

### 2.2 Legal, Regulatory and Investment Structures

Retail investors tend to invest in conventional mutual funds and ETFs due to their availability through bank branches and mutual fund dealers that have lower minimum account size requirements. High net worth individuals often invest in a lower management fee class of conventional mutual funds and in ETFs, but also are the target audience for non-redeemable investment funds since these investors tend to have accounts at full-service investment dealers that can sell these funds. High net worth individuals also invest in pooled funds, particularly if their account is managed by a portfolio manager that delivers its strategies through a pooled fund. Institutional investors invest in both conventional mutual funds and pooled funds because they are able to negotiate lower management fees for their assets in these funds. All types of investors may invest a portion of their assets in alternative mutual funds to achieve greater diversification.

### 2.3 Legal, Regulatory or Tax Themes/Issues

There have been recent efforts by the Canadian securities administrators to make investors more involved in their investment decisions through streamlined documents (such as fund facts). The Canadian securities administrators are also seeking to align more closely the interests of registered

salespeople with the interests of their clients through proposals such as a quasi 'best interests' standard and the elimination of certain embedded compensation.

In addition, the increased focus on the annual costs of operating an investment fund have increased the popularity of passively managed ETFs with significantly lower cost structures.

The sale of investment funds through online platforms remains at an early stage of development due to regulatory restrictions, but may see dramatic changes in the near future as the Canadian securities administrators become more comfortable with financial technology.

### 2.4 Restrictions on Investors

An investment fund that files a prospectus is legally permitted to issue its securities to any investor in Canada. However, the investor must place his or her order through a registered dealer. Provided the dealer is not an 'order execution only' dealer, a registered salesperson of the dealer must complete a know-your-client (KYC) review of the client's circumstances and confirm that the investment fund is suitable for the client, before placing the purchase order. This nexus is where investors may be limited from investing in certain types of investment funds.

An investor also may be precluded from investing in certain types of funds depending on the dealer with whom they have their account. While full-service investment dealers are qualified to sell any type of investment fund to their clients, they typically have minimum account size requirements beyond the reach of many retail investors. Those investors may, instead, have their account with a mutual fund dealer that is restricted to selling only conventional mutual funds. Mutual fund dealers cannot sell non-redeemable investment funds, generally do not have the proficiency to sell alternative mutual funds and may experience operational difficulties buying and selling ETFs for their clients.

Investors who are not 'accredited investors' cannot legally purchase pooled funds.

### 2.5 Marketing Restrictions

Public investment funds are required to comply with a common set of rules for marketing materials that has been adopted in all the Canadian jurisdictions. These rules generally regulate all communications made to potential investors, regardless of medium. The rules cover, among other matters:

- disclosure of past performance of the investment fund;
- comparisons of the performance of the investment fund to other investment funds and benchmarks; and
- prescribed warnings.

These rules are subject to an overarching requirement that the communication not be misleading.

The manner in which public mutual funds and their managers compensate, support and incentivise registered dealers and their salespeople to sell public mutual funds is regulated by a common set of sales practice rules that has been adopted in all the Canadian jurisdictions. These rules prohibit all forms of monetary and non-monetary benefits, except those expressly permitted in the rules. Managers of public mutual funds (but not the mutual funds themselves) are permitted to pay sales commissions and ongoing trailer fees within tightly controlled restrictions, as well as hold certain types of events promoting their funds and subsidise the costs of certain other events not organised by the manager.

None of the sales practices rules described above applies to the sale of non-redeemable investment funds or pooled funds.

It should be noted that marketing a fund to Canadian investors (including marketing a non-Canadian fund by its non-Canadian manager) can trigger a requirement to be registered as a dealer under Canadian securities legislation.

## 3. Regulatory Environment

### 3.1 Regulatory Regime

#### Categories of Regulated Activities

Canadian securities legislation differentiates between:

- giving advice to others regarding the securities they should own, which includes making decisions regarding how a fund's assets are invested (portfolio management);
- managing all the day-to-day operations of a fund (fund management) other than portfolio management; and
- executing trades to buy or sell securities (trading).

In most cases, a firm that performs fund management also performs portfolio management for some or all of the fund's assets since the activities are complementary, but the firm also may retain other firms to perform portfolio management for a portion or all of the fund's assets.

#### Requirements to be Registered

Unless an exemption from registration is available:

- any firm or individual that performs fund management must register with the relevant Canadian securities administrators as an 'investment fund manager';
- any firm or individual that engages in the business of giving investment advice to others (which includes portfolio management for a fund) must register with the relevant Canadian securities administrators as a 'portfolio manager'; and

- any firm that engages in the business of trading in securities (which includes executing orders to purchase, sell or redeem securities of an investment fund) must register with the relevant Canadian securities administrators as a 'dealer'.

Subject to limited exceptions, dealers also must be a member of the Investment Industry Regulatory Organization of Canada (IIROC) or the Mutual Fund Dealers Association of Canada (MFDA), depending on whether they are a full-service investment dealer or limited to selling mutual funds, respectively.

Obtaining and maintaining a registration described above is fairly onerous since the firm must (among other matters):

- demonstrate that it has adequate policies and procedures in place to comply with all Canadian securities legislation applicable to that registration (including, in the case of an investment fund manager, the regulations applicable to the investment funds it manages);
- employ a chief compliance officer who has completed certain prescribed courses and meets the prescribed minimum level of industry experience;
- in the case of a portfolio manager or dealer, employ one or more individuals as 'advising representatives' or 'dealing representatives', respectively, each of whom has completed certain prescribed courses and meets the minimum prescribed level of industry experience; and
- have a prescribed minimum amount of working capital and insurance coverage.

The timeline for a previously unregistered firm to obtain its first registration in Canada is approximately six months, but could be longer if the firm or any of its relevant personnel request a waiver of any of the specific conditions associated with the registration. Thereafter, the timeline for adding to or changing an existing registration is shorter, including extending an existing registration to one or more additional provinces or territories. Delays due to personnel not having completed the prescribed courses or having the prescribed experience are the difficulties most commonly encountered with the registration process.

Once registered, the firm and its registered individuals become subject to the jurisdiction of these Canadian securities administrators, which includes periodic filings, frequent field audits and requests for information, and potential sanctions for non-compliance. Accordingly, unless a non-Canadian firm intends to establish a significant presence in Canada, the firm usually structures its relationships and restricts its activities in a manner that qualifies for exemptions from the registration requirements that otherwise would apply.



**Investment Fund Manager Registration Exemptions**

There are two circumstances where a firm that manages an investment fund formed outside of Canada and has one or more Canadian resident investors is exempt from the requirement to register as an investment fund manager.

The first circumstance is where the fund manager has not actively solicited Canadian residents to invest in the fund. This allows the manager to accept unsolicited purchase orders from Canadian investors. It also is the basis on which non-Canadian investment funds that trade on a non-Canadian exchange can have Canadian resident investors.

The second circumstance is where the manager only solicits investments from Canadian residents who are ‘permitted clients’ under Canadian securities legislation. ‘Permitted clients’ are a prescribed list of sophisticated investors that includes Canadian financial institutions, pension plans, Canadian portfolio managers for their managed accounts, individuals with financial assets exceeding CAD5 million, and companies with net assets exceeding CAD25 million. In order to rely on this exemption, the fund manager also must file documents with the relevant Canadian securities administrators giving notice that the fund manager is relying on the exemption, as well as annually file a report and pay a fee. The fund manager also must provide Canadian investors with certain prescribed disclosure regarding the risks associated with the fund manager being located outside of Canada.

**Portfolio Manager Registration Exemptions**

Non-Canadian firms that are advisers in their home jurisdictions on a registered or registration-exempt basis, are exempt from the requirement to register in Canada as a portfolio manager in two circumstances.

The first circumstance, referred to as the ‘international sub-adviser exemption’, is where the non-Canadian firm is retained by a Canadian registered portfolio manager and the Canadian registered portfolio manager takes responsibility for any losses incurred by the investment fund, resulting from the non-Canadian firm failing to meet a prescribed standard of care.

The second circumstance, referred to as the ‘international adviser exemption’, is available if the non-Canadian firm provides its advice only to certain permitted clients, which includes Canadian investment funds, and if not more than 10% of the aggregate consolidated gross revenue of the firm and its affiliates is derived from portfolio management activities in Canada. If relying on this exemption, the firm must limit its advice to non-Canadian securities (except for incidental advice regarding Canadian securities). The firm also must file documents with the relevant Canadian securities administrators giving notice that it is relying on the exemption, as well as annually file a report and pay a fee. Finally, the firm must provide Canadian clients with certain prescribed

disclosure regarding the risks associated with the firm being located outside of Canada.

**Dealer Registration Exemption**

A non-Canadian firm is exempt from the requirement to register in Canada as a dealer in order to market and sell its non-Canadian funds to Canadian investors in circumstances known as the ‘international dealer exemption.’ To qualify for this exemption, the firm must be registered as a dealer, and carry on the business of a dealer, in its home jurisdiction, and limit its marketing to Canadian residents who are ‘permitted clients.’ Similar to the international adviser exemption, the firm must file documents with, and pay fees to, the relevant Canadian securities administrators and provide Canadian clients with prescribed disclosure.

**3.2 Territorial Reach of Regulators****Jurisdiction Over Portfolio Management**

A Canadian securities administrator will assert jurisdiction if a non-Canadian firm provides investment advice to a person in Canada (including portfolio management for a Canadian investment fund), even if all the activities of the non-Canadian firm occur outside of Canada. This triggers a requirement to register as a portfolio manager, but there are two possible exemptions, described above, that may be relied upon by the firm to avoid that registration in Canada.

A non-Canadian firm that provides portfolio management to a non-Canadian investment fund does not trigger a requirement to be registered as a portfolio manager in Canada, even if the non-Canadian fund has one or more Canadian investors. However, offering a non-Canadian fund to Canadian investors may trigger a requirement for someone to be registered in Canada as an investment fund manager and dealer, as described above.

**Jurisdiction Over Fund Management**

A Canadian securities administrator will assert jurisdiction over the manager of an investment fund formed in their jurisdiction and, in the case of Ontario, Québec, and Newfoundland and Labrador, any investment fund with investors resident in their jurisdiction. This triggers a requirement for the fund manager to register as an investment fund manager unless the fund manager can rely on one of the two exemptions from registration described above.

**Jurisdiction Over Trading**

A Canadian securities administrator will assert jurisdiction over a firm if the firm performs any activity in Canada (which includes marketing activity) that leads to a Canadian investor purchasing securities of an investment fund, even if the investment fund is formed and operated entirely outside of Canada. This triggers a requirement to register as a dealer, unless the firm can rely on the international dealer exemption described above.

### 3.3 Regulatory Approval

Marketing investment funds constitutes a form of ‘trading’ activity and, if the offering is made to the public for securities to be issued by an investment fund, must be approved by the relevant Canadian securities administrators accepting a prospectus for the offering. If the offering instead is made as a prospectus-exempt distribution, it does not require regulatory approval.

Marketing investment funds triggers a requirement to be registered as a dealer with the relevant Canadian securities administrators unless an exemption from registration is available in the circumstances.

### 3.4 Authorisation of Marketing Activities

Any communications with Canadian residents in connection with their possible purchase of securities of an investment fund constitutes ‘trading’ in those securities in Canada and the party making the communication must be either registered as a dealer or able to rely on an exemption from registration. Where the communication is an invitation to the public to purchase securities of an investment fund, the fund must have filed a prospectus that was reviewed and accepted by the Canadian securities administrators. Other types of activities (such as advertising and sales presentations) are regulated, but do not require prior authorisation from the Canadian securities administrators.

### 3.5 Investor-Protection Rules

Only accredited investors may purchase securities of a pooled fund. Any other investment fund which makes a public offering of its securities can be purchased by any investor, provided the investor’s dealer holds the necessary registration to execute the purchase and the dealer’s salesperson has confirmed that the purchase is suitable for the investor.

### 3.6 Approach of the Regulator

There are some differences in approach between the Canadian securities administrators based upon (among other factors): the manpower and expertise of the regulator, the size of the local capital market it regulates, and the relative importance of encouraging capital markets activity in its jurisdiction. This can be seen in enforcement matters for non-compliance where some regulators are more likely to seek a formal acknowledgement of wrongdoing coupled with a sanction (typically a fine), while other regulators may be content with a commitment from the party to remedy the non-compliance and improve systems to prevent its recurrence.

Each Canadian securities administrator generally has the authority to enact new securities legislation in its jurisdiction after following a quasi-legislative process (called ‘rule-making’) involving public consultation. On a shorter-term basis, some regulators will exercise discretionary powers

under their legislation to effect change. When this happens, the regulator sometimes will publish a notice which describes the concern and the manner in which the discretionary power will be exercised.

Some Canadian securities administrators (particularly the OSC) publish guidance in other forms, including the results of their audits of market participants for specific issues, and their statement of priorities for the coming year. Several times each year, the OSC also publishes a document it refers to as The Investment Funds Practitioner, which describes recent issues it encountered in the investment funds industry and its views on those issues.

## 4. Fund Finance

### 4.1 Access to Fund Finance

A manager’s subscription financing (such as to pay sales commission) typically is obtained through a credit facility with a Canadian bank. Financing for an investment fund to leverage its portfolio is available from a variety of sources, subject to restrictions in Canadian securities legislation on borrowing cash and using leverage which vary depending on the categorisation of the fund under Canadian securities legislation.

### 4.2 Borrowing Restrictions/Requirements

Conventional mutual funds are prohibited from borrowing cash except as a temporary measure to fund payment on the redemption of their securities, or to facilitate settlement in trading in portfolio securities; providing that, in either case, the aggregate amount borrowed does not exceed 5% of the fund’s net asset value. As a policy matter, conventional mutual funds are not allowed to leverage their portfolios.

Alternative mutual funds and non-redeemable investment funds are permitted to borrow cash up to 50% of their net asset value, which may be used for any reason, including to purchase additional portfolio securities. However, there are restrictions on the parties from whom these funds can borrow cash.

There are no restrictions on the ability of a pooled fund to borrow cash.

### 4.3 Securing Finance

To the extent that conventional mutual funds borrow cash the borrowing typically is made from the fund’s custodian.

Non-redeemable investment funds that intend to borrow to leverage their portfolios often establish a credit facility with a financial institution. Short selling and derivatives are other means by which a non-redeemable investment fund can obtain additional cash or market exposure for its portfolio. Alternative mutual funds are likely to follow the same

approaches as non-redeemable investment funds for borrowing and adding leverage to their portfolios.

#### 4.4 Common Issues in Relation to Fund Finance

Financing through credit facilities to fund commissions paid to dealers is well established. The principal issue with arranging financing tends to be the financial terms offered by the lender.

## 5. Tax Environment

### 5.1 Tax Framework

The differences in Canadian tax treatment of fund structures and their investors is the primary reason for selecting one fund structure over another. The manner in which a fund is categorised under Canadian securities legislation generally has no impact on how it is taxed.

#### Taxation of Trust Funds

A trust structure is attractive from a tax perspective because a trust does not pay tax on any income (including capital gains) it distributes to unitholders in the year. Consequently, it is common practice for a trust fund to distribute all of its net income annually to its unitholders, and provide that the distribution is automatically reinvested in additional units of the fund, unless the unitholder elects otherwise.

#### Taxation of Corporate Funds

A corporate fund can have three types of income:

- Canadian dividends, which are subject to a refundable tax in Canada;
- taxable capital gains, which are subject to a refundable tax in Canada through a redemption formula and by paying capital gains dividends to its shareholders; and
- other income (such as non-Canadian dividends, interest from bonds and returns from cash-settled derivatives), which is subject to non-refundable tax in Canada.

A corporate fund may pay certain dividends to its shareholders in order to receive a refund of taxes under the refund mechanisms described above. Consequently, it is common practice for a corporate fund to pay these dividends at least annually to its shareholders, and provide that the dividend is automatically reinvested in additional shares of the fund, unless the shareholder elects otherwise.

A corporation is a single taxpayer under Canadian tax laws, even if it is a multi-fund corporation. Since a multi-fund corporation calculates its net income for the corporation as a whole rather than on a fund-by-fund basis, this creates an opportunity for the fully taxable income earned in one fund to be offset by the deductible expenses (principally management fees) incurred by other funds within the corporation.

#### Taxation of Limited Partnerships

A limited partnership is not subject to Canadian tax and instead allocates both its income and its losses to its investors. It is used principally when the investment fund expects to have net losses for a period of time. A mere allocation is sufficient – a limited partnership is not required to actually distribute its net income to its partners. Securities of a limited partnership cannot be purchased by a tax-advantaged account and is the principal reason why Canadian investment funds rarely are structured as limited partnerships.

### 5.2 Tax Treaty Network

When a Canadian investment fund distributes income to a non-resident investor, the fund is required to withhold tax at the rate of 25%, unless the treaty between Canada and the investor's jurisdiction of residence provides for a lower rate of withholding.

### 5.3 FATCA and CRS Regimes

Canadian investment funds are subject to, and generally satisfy, their obligations under Canadian law for enhanced tax reporting to the Canada Revenue Agency. As a result, certain investors in Canadian investment funds may be requested to provide information to the fund or their dealer relating to their citizenship, residency and, if applicable, a US federal tax identification number or such information relating to the controlling persons in the case of certain entities. If an investor or any of the controlling persons of certain entities is identified as a US taxpayer or if the investor does not provide the requested information, Canadian tax laws will generally require information about the investor's investment in the fund to be reported to the Canada Revenue Agency, unless the investment is held in a tax-advantaged account. The Canada Revenue Agency then exchanges the information with the US Internal Revenue Service.

Canadian tax laws also include equivalent provisions for accounts held by residents of foreign countries (other than the US) where the collected information is exchanged on a reciprocal, bilateral basis with the countries that have agreed to a bilateral information exchange with Canada in which the account holders (or their controlling persons) are resident.

### 5.4 Tax Structuring Preferences of Investors

#### Investments Held Outside a Tax-Advantaged Account

Where an investor holds units of a trust fund outside a tax-advantaged account, any income distributed by the fund to the investor (including reinvested distributions) must be included in the investor's income and is taxed at the investor's marginal rate.

Where an investor holds shares of a corporate fund outside a tax-advantaged account, dividends (including reinvested dividends) paid by a corporate fund to the investor must be included in the investor's income. Dividends may include

ordinary taxable dividends or capital gains dividends. Ordinary taxable dividends are subject to gross-up and dividend tax credit rules that apply to taxable dividends received from taxable Canadian corporations. Capital gains dividends are treated as capital gains realised by the investor. In general, an investor must include one half of the amount of a capital gain in the investor's income for tax purposes.

Both a trust fund and a corporate fund can pay cash distributions that are a return of capital. These distributions are not taxable when received by the investor, but will reduce the adjusted cost base of the investor's securities in the fund, which will have the effect of increasing the size of the capital gain (or reducing the size of the capital loss) realised by the investor when they eventually dispose of their securities.

### **Investments Held in a Tax-Advantaged Account**

Much of the investment by Canadian individuals in investment funds is through one or more forms of tax-advantaged accounts that defer tax on any returns generated inside the account until assets are withdrawn from the account. Securities of an investment fund must satisfy certain requirements under Canadian tax laws before they can be held in a tax-advantaged account. Generally, the units of a public trust fund and the shares of a public corporate fund can be held in a tax-advantaged account. In these cases, no tax is payable at the time the distribution or dividend is received. Instead, tax is payable at the investor's marginal rate at the time cash is withdrawn from the account.

## **6. Miscellaneous**

### **6.1 Asset Management Industry Bodies**

The Investment Funds Institute of Canada (IFIC) represents both the managers of investment funds and the dealers that sell them. Its principal role is to advocate on behalf of the industry and its investors to ensure their voices are heard by the Canadian securities administrators and public policy makers considering the framework of rules that govern Canadian investment funds.

The Canadian ETF Association (CETFA) represents the managers of ETFs. Its primary goals are to create more awareness about ETFs and provide greater depth of education to investors about their usage, and deal with industry-specific issues, whether they are regulatory or structural, that affect its member firms.

The Portfolio Managers Association of Canada (PMAC) represents a large number of portfolio management firms. Its objectives include:

- advocating its members' views to the Canadian securities administrators and other government agencies;

- increasing public awareness of independent portfolio management and its benefits; and
- providing business services to its members.

The Alternative Investment Management Association (AIMA) Canada acts as the voice of the alternative investment industry in Canada. AIMA Canada's corporate members include hedge fund managers, institutional investors, pension fund managers and consultants, administrators, auditors, lawyers, prime brokers and other service providers.

The Investment Industry Association of Canada (IIAC) represents the position of full-service dealers in Canada on securities regulation, public policy and industry issues. It seeks to achieve greater awareness of business and industry trends, and supports its members with an array of services to ensure their ongoing success.

### **6.2 Preference for Courts or Arbitration**

Agreements between an investment fund (or its manager) and its service providers (including portfolio managers and custodians) typically contain provisions requiring that the parties submit any disputes to arbitration.

Documentation between an investment fund and its securityholders typically is silent on the issue, since disputes tend to be resolved informally, except when class action lawsuits arise.

If a dispute arises between a client and his or her portfolio manager or dealer, their firm is required by Canadian securities legislation to follow a procedure that includes an option for the client to refer the dispute to the Ombudsman for Banking Services and Investments.

### **6.3 Level of Litigation/Arbitration**

It is relatively uncommon for litigation or arbitration to arise between an investment fund and its securityholders due to the relatively small amounts invested by any single investor in a fund. The exception is class action lawsuits which may commence once a securities regulator has announced that it is commencing enforcement proceedings against an investment fund or its manager. Enforcement proceedings often conclude with the manager agreeing to pay restitution to affected investors, which can effectively eliminate the damages that otherwise would be the grounds for the class action lawsuit.

### **6.4 Periodic Reporting Requirements**

The ongoing disclosure requirements applicable to an investment fund under Canadian securities legislation depend upon whether the fund is formed in Canada and whether the fund has made a public offering of its securities in Canada.

All investment funds formed in Canada must provide periodic 'continuous disclosure' to their investors which

includes audited annual financial statements and unaudited semi-annual financial statements. If the investment fund is a 'reporting issuer', it also must prepare management reports of fund performance for each set of its financial statements, an annual information form and other reports. The continuous disclosure by reporting issuers is publicly available on the website maintained by the Canadian securities administrators for this purpose under their System for Electronic Document Analysis and Retrieval (SEDAR), while the continuous disclosure by pooled funds generally is confidential.

An investment fund that is a reporting issuer also must make 'timely disclosure' of any material change to its business or affairs that a reasonable investor may consider material in deciding whether to purchase or continue holding securities of the fund. Timely disclosure includes promptly issuing a press release and filing a material change report and, if the fund currently is offering its securities under a prospectus, filing an amendment to the prospectus. All timely disclosure is publicly available on the SEDAR website.

### 6.5 Powers of Attorney

Investors generally cannot grant a power of attorney to a fund's manager regarding investment decisions of the investor. Such authority would result in the investor becoming a direct client of the manager, which then would trigger KYC and suitability obligations. Powers of attorney for other purposes generally are not sought by fund managers from investors.

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