Regulatory compliance of foreign private equity and hedge funds sales to Canada

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So, you have a Canadian investor for your funds – Now what?

With so many Canadian pension plans and other institutions shifting their investment mix to include more offshore products, foreign fund managers are increasingly looking to Canada to sell their products. However, be careful to look before you leap, as you will have to navigate Canada's unique regulatory environment. Even the simple task of marketing your fund to a Canadian investor can put you offside Canadian securities law if you do not have a dealer that is authorized or exempt in the relevant jurisdiction of Canada with you at the pitch meetings. The Canadian regulatory regime has several steps, which foreign managers often miss regarding certain necessary pre-and post-closing filings.

Background

The various registration, disclosure and filing obligations that exist when selling funds into Canada are not particularly onerous. Nonetheless, they must be complied with or you risk regulatory sanctions in Canada that are likely also reportable to your home regulator. In this primer, we highlight the key areas that often trip up non-Canadian managers.

Securities laws in Canada are regulated at the provincial level. Accordingly, the requirements set out below must be reviewed and, if applicable, met in each province and territory in which a prospective investor resides in Canada. For the most part, these laws are harmonized, however, there are some differences that need to be considered if a fund product is marketed to investors in multiple provinces and territories.

The prospectus regime

In Canada, interests in funds are securities. Sales of securities to investors in Canada may only be made, absent an exemption, by way of a prospectus that has been vetted by the applicable Canadian securities regulatory authority. There are ongoing regulatory

compliance and reporting requirements applicable to funds and their managers that are sold to the general public.

Much like in the U.S., there is a variety of exemptions from the above prospectus requirement available in Canada that can be used for the private placement of fund products to investors. Most importantly for funds are the exemptions for sales to accredited investors (without any minimum purchase requirement) and/or to non-individual investors purchasing securities of a single class or series with an aggregate purchase price of C$150,000 or more. Accredited investors include financial institutions, pension funds, government agencies, various entities and high net worth individuals.

Registration of fund managers and intermediaries – Dealer registration

The marketing of securities in Canada to prospective investors is, broadly speaking, a registrable trading activity for which the entity that is doing the marketing – be it the fund, the fund manager or an intermediary (e.g. a placement agent) – may require registration as a dealer with the applicable securities commission(s), or an exemption therefrom. The manager of the fund that is being marketed in Canada may also become subject to a separate registration requirement in the category of "investment fund manager" as a result of these marketing activities, even if it is not doing the marketing. This is discussed in detail below.

The need for dealer registration in Canada is determined via a "business trigger" test. An entity that is "in the business" of trading in securities must be registered as a dealer (or avail itself of an exemption), or act solely through an agent who is registered or exempt.

Open-ended "investment funds" (or closed-end "investment funds" when in the course of their distribution periods) are often considered to be "in the business" of trading in securities in Canada, and must ensure that they (and their agents) are aware of the dealer registration requirements. An "investment fund" is essentially a commingled vehicle that holds a basket of underlying issuers for passive investment purposes. It does not invest for the purposes of exercising or seeking to exercise control of an issuer in which it invests or being actively involved in the day-to-day management of such an issuer. Broadly speaking, "investment funds" encompass typical '40 Act' funds, other pooled and hedge funds and UCITS, among others. Venture capital funds, private equity funds and real estate/infrastructure funds would likely not be considered to be "investment funds" under Canadian law and, as such, are not generally deemed to be in the "business of trading" in securities in Canada. However, that does not mean that the manager and/or any intermediaries involved in their marketing in Canada automatically avoid registration. There are varieties of factors that must be examined in each case to determine what parties are caught by the rules – and to what extent.

While the actual distribution of fund interests to an investor in Canada is caught by the definition of "trading" (and generally require that the distribution be processed through a dealer that is registered or exempt in Canada to transact in such interests), any act, advertisement, solicitation, conduct, or negotiation (directly or indirectly) in furtherance of that distribution is also caught. Accordingly, those that participate in the marketing and sale of a fund's securities to potential investors in Canada must determine whether

they trigger the dealer registration requirement in the relevant jurisdictions of Canada. If they do, they must register as a dealer in the applicable jurisdictions (or be exempt from registration) or the fund must be sold through another third party registered dealer, where required.

The most common of these exemptions is the so-called “international dealer exemption” which permits registered foreign dealers (such as, FINRA members) to market, sell and distribute non-Canadian funds to institutional and super high net-worth investors in Canada.

It is important that foreign fund managers do not market their funds directly to potential investors in Canada without the involvement of a registered or exempt placement agent where required, unless they themselves are registered or exempt. It is important to note that it may not be enough to bring a registered dealer into the equation only for the sole purpose of closing the investment. If relying on the dealer registration/exemption of an intermediary, it will also be important to involve them in the marketing process. Involving a dealer of record to “bless” the relevant trade after the marketing and offer have already been initiated does not retroactively cure the lack of required registration at the marketing stage.

Registration of fund managers and intermediaries – Investment fund manager registration

Another registration requirement that must be examined when selling funds into Canada is whether the entity that directs the business, operations or affairs of an “investment fund” that is marketed and sold in Canada requires registration as an “investment fund manager”. The regime is similar to the Alternative Investment Fund Managers regime in Europe (known as the AIFMD), in that Canada regulates the administrative manager of the fund, except that Canada has generous exemptions from registration when dealing only with institutional investors.

In three Canadian provinces (Ontario, Québec and Newfoundland & Labrador), simply having a fund investor resident in the province triggers the requirement for the manager of the fund to register as an investment fund manager or to find an exemption from it. In the remaining Canadian provinces, foreign managers will typically not trigger the registration requirement.

There are currently only 2 exemptions from the investment fund manager registration requirement in the 3 provinces mentioned above: (i) where neither the manager nor the funds has actively solicited investors in the relevant provinces since September 28, 2012 (or paid any third party to do so) or (ii) where active solicitation has taken place, but the fund is only marketed and sold in the above provinces to investors that qualify as “permitted clients” (essentially, a QIB or QP standard). The second exemption requires that certain filings be made to the authorities in order to rely on it, which must be renewed annually, and you will be required to pay fees in Ontario to maintain the exemption each year

Registration of fund managers and intermediaries – Adviser registration

Portfolio managers to investment funds must consider whether they require registration themselves as an adviser in Canada. Generally, they do not. This is because where both the portfolio manager and the fund are domiciled outside of Canada and all portfolio management activities take place outside of Canada, adviser registration is not triggered in Canada. However, advisers outside of Canada who wish to offer their services to Canadian investors through separately managed accounts must either register as an adviser in Canada or rely on an exemption from such registration, for example, the exemptions that are available to “international advisers” or to certain non-resident sub-advisers to registered portfolio managers in Canada.

Disclosure, reporting and filing obligations

There are certain pre- and post-closing disclosure and filing obligations that exist when selling funds into Canada, especially where an offering document is provided to prospective investors.

There is no requirement in any province or territory of Canada to provide an offering memorandum (OM) or equivalent disclosure document to an investor in connection with the sale of a fund where the prospectus exemptions discussed above are used. However, in most Canadian provinces, where a document that meets the definition of an OM under Canadian securities laws is provided to an investor in connection with the sale of fund units (for example, to an accredited investor), there will be statutory liability for any misrepresentation in that OM. Most foreign offering documents will meet such definition. In such cases, a summary of these statutory rights must be provided to the Canadian investor (subject to certain exceptions), which is customarily accomplished through a Canadian supplement or “wrapper” to the OM and/or subscription agreement, so that the non-Canadian documents need not be amended for Canadian investors. The wrapper also contains certain representations and warranties that the manager and the fund will want from its Canadian investors, as well as certain disclosures that the fund and/or manager must make to such investors.

In addition, certain provinces require that any OM (and its related wrapper) be filed with the securities regulatory authority in that province after closing.

Finally, sales of fund units in Canada must typically be reported to the securities regulatory authority in each province in which it was sold by completing a detailed form, similar to a Form D filing. There are filing fees in most provinces, and in certain provinces, late fees may be applicable.

In addition to the above, there may be monthly filings under Canadian anti-money laundering legislation in connection with the manager’s activities in Canada.

Conclusion

The purpose of this broad outline is to give the reader an overall appreciation of the essential elements associated with offering, marketing and selling commingled investment vehicles in Canada.

While the rules and requirements in Canada are similar to those of the United States, they are not identical, and this regulatory process guide will help you maintain positive relationships with regulators –both in Canada and in the United States.

While Canadian institutional investors may come knocking to buy into your fund, it is worth taking the time to know the applicable rules before you answer the door.

By

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