

International **Comparative** Legal Guides



Public Investment Funds **2020**

A practical cross-border insight into public investment funds

Third Edition

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1 Registration

1.1 Are funds that are offered to the public required to be registered under the securities laws of your jurisdiction? If so, what are the factors and criteria that determine whether a fund is required to be registered?

For Canadian securities regulatory purposes, an investment fund is either an open-end fund (referred to in Canada as a “mutual fund”) or closed-end fund (referred to in Canada as a “non-redeemable investment fund”) that offers liquidity, takes passive positions in securities, and does not try to exercise control or otherwise influence the day-to-day business of the investee issuer. Publicly offered non-redeemable investment funds and publicly offered mutual funds that are exchange-traded funds (“ETFs”) typically have their securities listed on a Canadian stock exchange. If an investment fund seeks to offer its securities to the public, it must comply with the requirements described in question 1.2 below.

1.2 What does the fund registration process involve, e.g., what documents are required to be filed?

In general terms, the conduct of a retail investment fund business in Canada gives rise to four fundamental securities regulatory filing and approval requirements:

1. The requirement to prepare and file with the securities regulatory authorities in Canada (the “Securities Regulator”) a prospectus and annual information form describing the material facts relating to the offering of investment fund securities (the “Prospectus Requirement”). The type of prospectus that is used in the offering of a retail investment fund is subject to National Instrument 81-101 Mutual Fund Prospectus Disclosure (“NI 81-101”) which mandates the preparation of a simplified prospectus, an annual information form (“AIF”), and a fund facts document (“Fund Facts”) for each series or class of the mutual fund.

The simplified prospectus is divided into two parts: Part A which contains general information about mutual funds and introductory information about all mutual funds in a fund family; and Part B which contains specific information

about each fund within a family. The simplified prospectus format permits several mutual funds under common management to be offered together in a single document. Until recently, the simplified prospectus was required to be delivered to investors, but is now only filed with, and reviewed by, the Securities Regulator, and is available for inspection by the public on SEDAR (the Canadian version of EDGAR).

The AIF contains more detailed disclosure about the mutual fund, and although filed with, and reviewed by, the Securities Regulator, it is not required to be delivered to investors. Like the simplified prospectus, the AIF is available on SEDAR.

The Fund Facts document highlights key information that is important to investors, in a “plain language” format they can easily understand, and must be no more than two double-sided pages. The Fund Facts document content requirements are set out in NI 81-101 and include basic information about the fund followed by a concise explanation of mutual fund performance, expenses and fees, advisor compensation and the investor’s cancellation rights. A separate Fund Facts document must be prepared for each series or class of the mutual fund. The Fund Facts document must be filed and posted on the website of the mutual fund or the mutual fund manager. The Fund Facts document must be delivered to the investor prior to the dealer accepting an order to purchase from the investor.

For publicly offered investment funds that are non-redeemable investment funds, a long form prospectus is delivered to investors at the time of initial offering *in lieu* of the “simplified” prospectus and Fund Facts.

2. The requirement to have the fund’s investment manager registered under applicable securities laws (the “Investment Fund Manager Registration Requirement”). This requirement involves the filing of Form 33-109 F6 on behalf of the firm and the filing of Form 33-109 F4 on behalf of registered individuals.
3. The requirement to have the investment fund’s portfolio managed by an adviser registered under applicable securities laws (the “Adviser Registration Requirement”). This requirement involves the filing of Form 33-109 F6 on behalf of the firm and the filing of Form 33-109 F4 on behalf of registered individuals.

4. The requirement to distribute the investment fund securities through dealers registered under applicable securities laws (the “Dealer Registration Requirement”). This requirement involves the filing of Form 33-109 F6 on behalf of the firm and the filing of Form 33-109 F4 on behalf of registered individuals.

Each of these filings and registrations must be obtained prior to the commencement of the offering of any investment fund securities to the public in a Canadian province or territory.

1.3 What are the consequences for failing to register a fund that is required to be registered in your jurisdiction?

Failure to comply with the requirements described in question 1.2 above would constitute a breach of Canadian securities laws, the consequences of which include fines and other significant sanctions.

1.4 Are there local residency or other local qualification requirements that a fund must meet in order to register in your jurisdiction? Or are foreign funds permitted to register in your jurisdiction?

While the investment fund itself and its custodian must be domiciled and resident in Canada, the investment fund manager and portfolio adviser may be located outside of Canada. An investment fund established and custodied in a foreign jurisdiction may not be offered on a retail basis in Canada but may be offered to Canadian institutional investors or high-net-worth individuals through Canadian registered dealers or by foreign broker dealers that qualify for the international dealer exemption. Certain minimum Canadian residency requirements apply to directors of investment funds that are structured as corporations or as classes of shares of a corporation. These residency requirements vary by province and territory.

2 Regulatory Framework

2.1 What are the main regulatory restrictions and requirements that a public fund must comply with in the following areas, if any? Are there other main areas of regulation that are imposed on public funds?

i. Governance

The Canadian securities markets are currently regulated solely by the provincial and territorial governments. As a result, each of Canada’s 10 provinces and three territories has its own legislative scheme for regulating the securities market within its own provincial or territorial jurisdiction and its own Securities Regulator for administering and enforcing such legislation. Securities regulatory requirements in Canada can therefore vary from jurisdiction to jurisdiction.

In an effort to harmonise Canadian securities laws, each of the 13 Securities Regulators in Canada have, under rule-making authority granted by the provincial and territorial governments, established numerous rules, referred to as “national instruments”, that operate in a substantially identical manner in each province and territory.

Notwithstanding the potential for inconsistent regulatory requirements between the provinces, there is significant harmonisation of securities market regulation in Canada and this recognition has resulted in the Securities Regulators collaborating in the development of a number of key national instruments or policies including:

- National Policy 11-202 Process for Prospectus Reviews in Multiple Jurisdictions (“NP 11-102”) which describes procedures for the filing and review of a preliminary prospectus, prospectus and related materials in more than one Canadian jurisdiction.
- National Instrument 31-103 Registration Requirements, Exemptions and Ongoing Registrant Obligations (“NI 31-103”) which imposes registration categories and requirements for individuals and firms, registration exemptions, internal controls and systems, capital and insurance requirements and client relationship principles.
- National Instrument 33-109 Registration Information (“NI 33-109”) which sets out the required information for registration and allows regulators to assess a filer’s fitness for registration or for permitted individual status, with regard to their solvency, integrity and proficiency.
- National Instrument 62-103 The Early Warning System and Related Take-over Bid and Insider Reporting Issues (“NI 62-103”) which prescribes securities reporting rules relating to circumstances when a portfolio adviser acquires, on behalf of one or more investment funds or accounts managed by it, control or direction over 10% or more of a class of voting securities of a Canadian reporting issuer.
- National Instrument 81-101 Mutual Fund Prospectus Disclosure (“NI 81-101”) which is meant to ensure that the offering disclosure regime for mutual funds provides investors with disclosure documents that clearly and concisely state information that investors should consider in connection with an investment decision about the mutual fund, while recognising that different investors have differing needs in receiving disclosure.
- National Instrument 81-102 Investment Funds (“NI 81-102”) which imposes a uniform code of regulatory requirements upon all those involved in the management and distribution of retail investment funds in Canada.
- National Instrument 81-105 Investment Fund Sales Practices (“NI 81-105”) which imposes a code on cash payments and non-monetary benefits that may be paid or provided by a member of an investment fund organisation to a dealer.
- National Instrument 81-106 Investment Fund Continuous Disclosure (“NI 81-106”) which imposes continuous disclosure requirements for investment funds across Canada.
- National Instrument 81-107 Independent Review Committee for Investment Funds (“NI 81-107”) which imposes a minimum, consistent standard of independent oversight for all publicly offered investment funds to ensure that the interests of the investment fund (and ultimately, the investors) are at the forefront when an investment fund manager is faced with a conflict of interest.

ii. Selection of investment adviser, and review and approval of investment advisory agreement

The investment fund manager is responsible for the selection and oversight of the portfolio adviser. The portfolio adviser may retain sub-advisers.

iii. Capital structure

There are no restrictions regarding an investment fund’s legal form and capital structure. Tax, legal liability and market practice will often determine the appropriate structure for a fund’s specific purposes. Typically, investment funds are structured as one of the following:

- Trusts – publicly offered investment funds in Canada are most often structured as investment trusts, also frequently referred to as unit trusts. Investors are issued units and become unitholders of the fund and are the beneficiaries of the trust.
- Corporations – while most publicly offered investment funds in Canada are structured as trusts, investment funds can also be structured as corporations or as classes of shares of a corporation. Investors are issued shares and become shareholders of the fund.
- Limited partnerships – investment funds can also be structured as a limited partnership. This legal form is more common for hedge funds and other non-publicly offered investment funds. Investors are issued units and become limited partners of the limited partnership. It would be unusual to see a publicly offered investment fund in the form of a limited partnership.

iv. Limits on portfolio investments

NI 81-102 and certain other laws and regulatory instruments impose restrictions on portfolio investment activity. These restrictions pertain to prohibiting investments in parties related to the investment fund manager and portfolio adviser, prohibiting certain types of investments such as real property, control and concentration of portfolio positions, short selling, investment in other investment funds, illiquid investments, derivatives and securities lending.

v. Conflicts of interest

There are numerous rules pertaining to conflicts of interest. The principal rule is NI 81-107 which prescribes the establishment of an independent review committee to review matters that present a conflict of interest for the investment fund manager in respect of its fiduciary duty to the investment fund.

vi. Reporting and recordkeeping

NI 81-106 sets out the continuous disclosure requirements applicable to all investment funds, including publicly offered investment funds. Such continuous disclosure requirements include requirements to prepare, file with the Securities Regulator and/or deliver to investors:

- (i) annual and interim management reports of fund performance (“MRFPs”);
- (ii) annual and interim financial statements; and
- (iii) other continuous disclosure obligations such as disclosure of the proxy voting record and material change reports.

The continuous disclosure rules also provide details with respect to the calculation of the net asset value and management expense ratio of a mutual fund.

Investment fund managers are required to maintain investment fund records for at least seven years.

vii. Other

In addition to the abovementioned rules, publicly offered investment funds will usually also be subject to regulation in the areas of trading (e.g., best execution, short selling, institutional trade matching, insider trading, soft dollars), privacy and anti-spam laws. In addition, if the investment fund is publicly offered in the Province of Quebec, Quebec’s Charter of the French Language establishes French as the official language of the province of Quebec and prescribes French-language requirements with respect to certain documents. Canadian anti-money laundering and terrorist-financing legislation also applies to investment fund managers doing business in Canada.

2.2 Are investment advisers that advise public funds required to be registered and/or regulated in your jurisdiction? If so, what does the registration process involve?

Investment fund manager

The manager of an investment fund or group of investment funds is the entity responsible for administering the day-to-day operations of the investment fund or investment fund group and is generally considered to be the “operating mind” of the investment fund complex. In Canada, the investment fund manager of a publicly offered investment fund is subject to the Investment Fund Manager Registration Requirement. A registered investment fund manager is subject to a standard and duty of care of a fiduciary nature. The registration requirement involves a number of conditions of registration including capital requirements, insurance, audited financial statements and proficiency for the chief compliance officer.

Portfolio advisor

The entity responsible for the investment advice that is provided to publicly offered investment funds is subject to the Adviser Registration Requirement and must be registered as a portfolio manager with the Securities Regulator within the jurisdiction in which the publicly offered investment fund is established. Like the investment fund manager category of registration, registration as a portfolio manager involves a number of conditions of registration including capital requirements, audited financial statements and proficiency for advising representatives and the chief compliance officer. A registered portfolio manager is authorised to provide advice in respect of securities to any retail investment fund. If the advice was to include advice in respect of exchange-traded commodity futures contracts and options, registration as an adviser under commodity futures legislation would also be required depending upon the Canadian jurisdiction in which the investment fund was established.

Portfolio managers that are retained by other Canadian registered portfolio managers to act as “sub-advisers” to a publicly offered investment fund are often able to take advantage of an exemption from the Adviser Registration Requirement. In addition, non-resident portfolio managers to an investment fund that restrict their investment advice to non-Canadian securities may qualify for an exemption from the Adviser Registration Requirement.

2.3 In addition to the requirements above, are there additional regulatory restrictions and requirements imposed on investment advisers that advise public funds?

In most cases, a publicly offered investment fund would be precluded by law from owning 10% or more of a class of voting or equity securities of an issuer. However, the portfolio adviser to a publicly offered investment fund could nonetheless exercise control or direction over more than 10% of a class of voting or equity securities of a Canadian reporting issuer on an aggregate basis across all of its client accounts. Accordingly, a portfolio adviser needs to be aware that under Canadian securities law, a portfolio adviser to a publicly offered investment fund that invests in Canadian public company securities is subject to a shareholder position reporting requirement and is required to make regulatory filings with the Securities Regulator in the following circumstances:

- 10% report threshold – when the portfolio adviser acquires control or direction over voting or equity securities of any class of a Canadian reporting issuer (or securities

convertible into voting or equity securities of any class of a Canadian reporting issuer), that, together with the purchaser's securities of that class, constitute 10% or more of the outstanding securities of that class. This report must be filed within 10 days after the end of the month in which the threshold was reached.

- Subsequent increases and decreases in control or direction – a portfolio adviser who has met the 10% reporting threshold is required to report both increases and decreases above and below the 12.5%, 15% and 17.5% thresholds in control or direction. In addition, a portfolio adviser is required to report when their control or direction position has fallen below the 10% reporting threshold. This report must be filed within 10 days after the end of the month in which the threshold was reached.
- Change in material fact – when there has been a change in a material fact in the portfolio adviser's most recent report required to be filed.

Canadian take-over bid laws would be engaged if a portfolio adviser were to exercise control or direction over 20% or more of a class of voting or equity securities of a Canadian reporting issuer.

2.4 Are there any requirements or restrictions in your jurisdiction for public funds investing in digital currencies?

While there is no express prohibition in Canada against public funds investing in digital currencies, such investments must be carefully reviewed against restrictions pertaining to illiquid assets and custody requirements. A recent proposal by a Canadian fund manager to launch such a public fund was challenged by a Canadian regulator in part due to the illiquid nature of the digital currency in question. After a contested hearing on the matter, the digital offering was permitted to proceed.

2.5 Are there additional requirements in your jurisdiction for exchange-traded funds?

ETFs are offered by way of a long form prospectus and ETF Facts document, in prescribed form. The ETF Facts document is similar to the Fund Facts document and must be delivered to the ETF investor within two days of the dealer accepting an order to purchase from the investor. In order to list their securities on a Canadian stock exchange, ETFs must also meet the applicable listing requirements of the exchange.

3 Marketing of Public Funds

3.1 What regulatory frameworks apply to the marketing of public funds?

All sales of the securities of mutual funds are subject to the Dealer Registration Requirement and must therefore be made by a person or company that is registered in an appropriate category of dealer registration. The dealer registration categories that can accommodate the retail sale of mutual fund securities are the mutual fund dealer and investment dealer categories of dealer registration. A mutual fund dealer is authorised to trade mutual fund securities only. An investment dealer is authorised to sell any securities. Most investment fund managers elect to sell the securities of their mutual funds through persons or companies registered in either of these categories of dealer registration.

3.2 Is licensure with a regulatory authority required of persons (whether entities or natural persons) engaged in marketing activities? If so: (i) are there commonly available exceptions that may be relied on?; and (ii) describe the level of substantive regulation applied to licensed persons.

Marketing of investment fund securities is considered an act in furtherance of a trade of securities and must therefore be undertaken by a registered dealer. Investment fund managers qualify for an exemption from the dealer registration requirement to the extent that their marketing activities are restricted to wholesaling their own investment funds to registered dealers. Marketing activities that promote the investment fund manager's "brand" as opposed to a specific security generally do not trigger the Dealer Registration Requirement.

3.3 What are the main regulatory restrictions and requirements in the following areas, if any, that must be complied with by entities that are involved in marketing public funds?

i. Distribution fees or other charges

In addition to fixed filing fees applied by each Securities Regulators at the time of filing of initial Disclosure Documents or the mandatory annual renewal thereof, certain Securities Regulators also levy an annual fee equal to 0.04% of the dollar value of securities sold in the jurisdiction in the prior year.

ii. Advertising

NI 81-102 prescribes numerous rules pertaining to the advertising of public investment funds, including advertising of the fund's performance.

iii. Investor suitability

Investor suitability must be conducted by the registered dealer that sells the public investment fund to the investor. The key factors of the suitability assessment are the client's financial position, age, dependents, lifestyle, investment knowledge, investment objectives, risk tolerance and time horizon.

iv. Custody of investor funds or securities

The portfolio assets of a public investment fund must be held by a Canadian custodian that meets certain regulatory requirements. The Canadian custodian may retain foreign sub-custodians.

3.4 Are there restrictions on to whom public funds may be marketed or sold?

A public investment fund may be sold to any resident of Canada that has obtained the age of majority.

3.5 Are there other main areas of regulation that are imposed with respect to the marketing of public funds?

NI 81-105 applies restrictions in respect of sales practices on all investment fund managers and of publicly offered investment funds in Canada in respect of their arrangements with dealers that sell the investment funds to investors. Except as specifically permitted by NI 81-105, both monetary payments and the provision of non-monetary benefits by an investment fund manager to a dealer related to the sale of publicly offered investment funds are prohibited.

4 Tax Treatment

4.1 What are the types of entities that can be public funds in your jurisdiction?

Public funds may be structured as partnerships (usually limited partnerships), trusts and corporations. Co-ownership structures are rarely used.

4.2 What is the tax treatment of each such entity (both entity-level tax and taxation of investors in respect of allocations of income or distributions, as the case may be)?

A partnership is not itself liable to tax. Income (or loss) and capital gains (or capital losses) are calculated at the partnership level as if the partnership were a separate person resident in Canada and are allocated to the partners in accordance with the partnership agreement. The partners take into account their share of such amounts in computing their own income or loss, whether or not they receive a distribution in respect thereof. Amounts included in income increase the adjusted cost base (“ACB”) of the partner’s partnership interest. Distributions to a partner are not subject to tax but reduce the partner’s ACB of its interest. A partner may realise a capital gain (or capital loss) on the disposition of a partnership interest to the extent that the proceeds of disposition exceed (or are exceeded by) the ACB of the partnership interest. In Canada, only 50% of capital gains (“taxable capital gains”) are included in income and only 50% of capital losses (“allowable capital losses”) are deductible and only against taxable capital gains. If the ACB of a limited partner’s interest is negative at the end of a year, a deemed capital gain will arise.

A trust is liable to tax on its income (including taxable capital gains) but is generally entitled to deduct the amount of its income paid or payable in the taxation year to beneficiaries. A beneficiary must include in income its share of the trust’s income paid or payable to it. So-called “ancillary conduit” provisions permit the character of certain types of income which receive preferential tax treatment (such as dividends from taxable Canadian corporations) to retain their character in the hands of beneficiaries. Distributions to a beneficiary reduce the ACB of the beneficiary’s interest except to the extent that it is included in income or is the non-taxable portion of capital gains. A beneficiary may realise a capital gain (or capital loss) on the disposition of its interest or if its ACB becomes negative.

A corporation without special status (see below) is rarely used. Such a corporation is liable to tax on its income (other than dividends from other taxable Canadian corporations). A corporation is not entitled to claim a deduction for dividends or other distributions paid to shareholders. Shareholders must include dividends in income. In the case of a shareholder that is an individual, there is a partial credit given for tax paid at the corporate level and, in the case of a Canadian corporation, the recipient corporation is generally entitled to deduct the amount of the dividend in computing taxable income. A shareholder may realise a capital gain (or capital loss) on the disposition of its shares.

4.3 If a public fund, or a type of entity that may be a public fund, qualifies for a special tax regime, what are the requirements necessary to permit the entity to qualify for this special tax regime?

A trust that is a “mutual fund trust” (“MFT”) qualifies for a special tax regime. To be an MFT, a trust must generally:

- Be a “unit trust”, which requires that the interest of each beneficiary be described by reference to units and either at least 95% of the units (based on fair market value) are redeemable at the demand of the holder or the trust satisfies certain conditions with respect to the nature of its investments including a concentration restriction.
- Limit its activities to investing its funds in property (other than real property or interests therein) and/or acquiring, holding, maintaining, improving, leasing or managing real property or interests therein that are capital property.
- Be considered to have distributed a class of its units to the public, generally in accordance with a prospectus or offering memorandum, and in respect of a class of units so distributed, there must be 150 or more unitholders each holding not less than (1) one block of units of the class, and (2) units of the class having a total fair market value of at least \$500.

An MFT may be entitled to a “capital gains refund”, determined on a formula basis, which reduces the amount of capital gains the MFT must distribute to its unitholders and consequently the amount they must include in income. An MFT, by making appropriate distributions, should be able to avoid tax at the fund level on all sources of income.

Units of an MFT are “qualified investments” for a “registered retirement savings plan” and similar tax-deferred plans.

A corporation that is a “mutual fund corporation” (“MFC”) also qualifies for a special tax regime. This generally requires that:

- The corporation is a “public corporation” which requires either that (1) a class of its shares is listed on a designated stock exchange in Canada, or (2) it has elected to be a public corporation by distributing a class of its shares to the public, generally in accordance with a prospectus or offering memorandum, and depending on the attributes of the shares distributed, having 150 or more (or 300 or more) shareholders each holding not less than (1) one block of shares of the class, and (2) shares of the class having aggregate fair market value of at least \$500.
- The corporation limits its activities to investing its funds in the same way as an MFT.
- At least 95% (based on fair market value) of its issued shares are redeemable at the demand of the holder.

An MFC may elect to pay “capital gains dividends” out of realised capital gains which are treated as realised capital gains in the hands of shareholders and entitle the MFC to a refund of tax payable on such capital gains (“capital gains refund”). Like an MFT, an MFC may also be entitled to a capital gains refund based on a formula taking into account redemptions of its shares which reduces the amount of capital gains dividends to be paid to shareholders. An MFC is an efficient vehicle for investments that give rise to capital gains or taxable dividends from Canadian corporations. However, corporate level tax may be paid on income from other sources (e.g., interest and foreign income) unless the corporation has sufficient deductible expenses (such as management fees).



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