

Recent Developments in Offering US and Foreign Investment Funds to Retail Investors in Canada

By Patricia A. Koval, *Torys LLP*

Over the past year, US and foreign investment funds and their managers have had an increasing presence in the Canadian retail market. This has largely been seen in initial public offerings of exchange-listed funds and retail offerings of deposit and other “exempt” notes linked to underlying investment funds.

The growth has been spurred by several factors. First, and probably foremost, there has been tremendous Canadian retail investor appetite for a greater variety of investment products capable of delivering an attractive yield, compared to traditional investment products. Second, there has been increasing Canadian retail investor interest in hedge fund products offered by US and other international managers. Both of these demand factors have been accommodated by the ability of creative legal counsel and investment dealers to design cross-border structures, including “tax-advantaged” structures, to achieve these objectives within the framework of existing Canadian securities and tax laws.

This article will examine these developments, including the associated structures developed for these products. First, however, it is helpful to briefly review the critical aspects of the Canadian securities law environment and the Canadian

taxation system as they apply to the offering of US and other offshore funds into Canada.

The Canadian Securities Law Environment

As a general matter, an investment fund must sell its securities under a prospectus filed with Canadian securities regulators unless “accredited investor” or other exemptions are available. Dealers appropriately registered in the relevant Canadian jurisdictions must be involved in the distribution and trading of investment fund securities unless, again, exemptions are available. In addition, if an investment fund is primarily targeting Canadian investors and sells its securities to purchasers in Ontario, the investment advisor of that fund, regardless of the fund’s domicile, will generally be required to be registered as an advisor in Ontario.

The regulation of the offering and sale of investment funds in each province of Canada is governed by securities laws in each province, as opposed to single federal statutes comparable to the *Investment Company Act of 1940* and the *Investment Advisors Act of 1940* (US *Advisors Act*). Fortunately, much coordination between provinces has been achieved in recent years and significant uniformity exists in “national instruments”—rules that are cooperatively developed by the securities regulators of the various provinces and then adopted on a province-by-province basis.

Within this framework, significant differences exist between the regulation of publicly offered investment funds that are “mutual funds” for securities law purposes and those that are not. The form and content of the prospectus, and, indeed, the operation and administration of a publicly offered mutual fund, are strictly and specifically regulated. In general, an investment fund will be a mutual fund for this purpose if its securities are redeemable at least quarterly at a price calculated by reference to the net asset value of the investment fund’s assets.

In practice, however, uncertainty exists unless the redemption right is restricted to an annual right; in the latter case, Canadian securities regulators generally will not treat the investment fund as a mutual fund. If a redemption right is available more frequently—for example, on a daily or monthly basis—but the redemption price is calculated by reference to some factor other than net asset value—for example, the recent average market trading price of an investment fund’s securities on a stock exchange—Canadian securities regulators will also generally not regard that fund as a mutual fund. The significance of this determination cannot be overstated, because the national instruments that regulate mutual funds do not, in effect, permit non-Canadian-domiciled mutual funds to offer their securities to the public in Canada. (Similarly, under US laws, a mutual fund domiciled in Canada cannot publicly offer its securities in the United States.)

In stark contrast, investment funds that are not “mutual funds” for Canadian securities law purposes are not subject to any specific prospectus content rules; nor are they subject to the complex operation, administration and other rules that are otherwise prescribed for Canadian mutual funds. As a result, they can, for example, employ leverage, engage in short selling and use derivatives without restriction.

When the securities of an investment fund are sold to investors in Ontario, a “look-through” approach applies to the provision of investment advice. The Ontario Securities Commission adopts the approach (similar to the recent proposed approach of the Securities and Exchange Commission with respect to hedge funds) that the individual investors in an investment fund are receiving investment advice directly.

As a result, unless an exemption is available from the advisor registration rules, the investment advisor of the fund must be registered as an investment advisor in Ontario. One important exemption (which has proven useful in the product structures discussed below) is the exemption that exists for a non-Canadian investment advisor to provide investment advisory and portfolio management services to an investment fund when a Canadian entity that is registered as an advisor under the *Securities Act* (Ontario) has agreed to act as manager of the fund and to be responsible, ultimately, for the advice provided by the non-resident advisor.

Non-resident advisors, in any case, can obtain registration as advisors under the Ontario *Securities Act*, subject to compliance with applicable requirements, which include, notably, proficiency requirements. Generally, a US advisor registered under the US *Advisors Act* should be entitled to satisfy these proficiency requirements or obtain an exemption from them.

Canadian Taxation Considerations

Canadian investors typically seek to invest in funds that offer “flow-through” treatment and have no exposure to taxation on income or capital at the fund level. In Canada, an investment fund will meet these criteria if it qualifies as a “mutual fund” as defined in the *Income Tax Act* (which, notably, is a different definition from that for Canadian securities law purposes) and if the investment fund pays or makes payable to its investors amounts representing all of its income and capital gains. Investors are taxed on their income and capital gains (as defined in the *Income Tax Act*), with capital gains taxed most favorably: one-half of realized capital gains are subject to tax and can be offset in some circumstances by capital losses.

Canada’s income tax rules can create negative consequences for Canadians who invest directly in offshore funds. Most seriously affected are investments in non-resident trusts (other than trusts that are established as genuine arm’s length

pooled fund vehicles) but other rules, known as FIE (foreign investment entity) rules, affect investments in many types of non-Canadian corporations, trusts and certain partnerships.

The FIE rules are similar from a tax policy perspective to the US passive foreign investment company (PFIC) rules. Their basic purpose is to tax Canadian investors on an annual basis in respect of their “participating interests” in a FIE. Generally, a FIE is a non-resident entity whose total carrying value of the investment property is greater than 50 per cent of the total carrying value of all of its property at the end of the year.

Essentially, the rules are intended to catch foreign investment vehicles that accumulate (that is, do not distribute on a current basis) foreign income and capital gains that are either not taxed or taxed at low rates in a foreign jurisdiction. A “participating interest” in a FIE is very broadly defined and includes shares of a corporation or an interest in a trust or other non-resident entity, with certain exceptions.

The FIE rules apply to most Canadian taxpayers, including individuals, corporations, trusts and partnerships. Generally, where the rules apply, a Canadian taxpayer with a participating interest in a FIE is required to include in computing its income, for each taxation year in which the investment is held, an imputed rate of return on the investment, regardless of whether any amounts in respect of the investment are actually received.

Three methods are available to the taxpayer to compute this return. In practice, however, most retail investors are subject to a “prescribed rate of return” method, which will impute an amount of income to the Canadian taxpayer on a monthly basis equal to the applicable prescribed rate of interest (adjusted for the month) multiplied by the designated cost of the taxpayer’s participating interest in the FIE at the end of that month. The prescribed rate is set quarterly by the Canada Revenue Agency. For the third quarter of 2006, the prescribed rate is 6 per cent per annum. If imputed amounts are included in income, the rules do provide for deductions in respect of amounts that are subsequently actually received in respect of the investment.

Exchange-listed Funds

The Canadian investment market has been characterized in recent years by a demand for income-producing products that make regular cash distributions (usually monthly or quarterly) and, in particular, for products that offer a relatively high after-tax yield. US investment managers with good investment performance records in managing portfolios of income-producing securities, including debt and traditional fixed-income securities, mortgages, mortgage-backed and asset-backed securities, REITs and certain types of preferred securities, have been sought out by Canadian investment

dealers to create and launch retail investment funds that list their securities on the Toronto Stock Exchange.

Generally, for tax-efficiency purposes, these retail investment funds use a two-tier structure involving an underlying trust, corporation or partnership. Under this structure, the investment fund that offers its securities to the Canadian retail public (the “top fund”) will typically be a Canadian trust that seeks to obtain exposure to the returns of a portfolio of income-producing securities held by an underlying fund managed and domiciled in the United States or an offshore jurisdiction through the use of a forward contract entered into with a financial institution counterparty.

The top fund will hold a portfolio of highly liquid, non-dividend-paying Canadian common shares selected by it and the counterparty and, under the terms of the forward contract, these securities will be sold forward in exchange for a payment, at maturity, equal to the value of the underlying fund. Monthly or quarterly pre-settlements will be permitted to fund distributions, expenses and any redemptions. In this manner, the top fund, which will be designed to be a “mutual fund” for Canadian income tax purposes (but not for Canadian securities law purposes) will receive payments equal to the returns on the underlying portfolio of income-producing securities and will be able to distribute these payments to unitholders in the form of distributions characterized as return of capital (which is non-taxable) or capital gains. Accordingly, with this structure, investors achieve a higher after-tax yield than would be possible from an investment directly in the income-producing securities.

The financial institution counterparty to the forward contract will typically hedge its exposure by borrowing common shares of the type held by the top fund and by investing directly in the underlying US or foreign fund. This mechanism will work effectively if there are no outbound withholding tax payments on distributions made by the underlying fund to the counterparty or entity level tax on the underlying fund and if the counterparty is taxed on a mark-to-market basis. In this way, there will be a direct match between the distributions made by the underlying fund and the resulting payments made by the counterparty to the top fund.

This structure also has the advantage of avoiding the application of the FIE rules. Canadian taxation authorities have recognized this in published rulings when the forward contract meets certain criteria. Recently, another type of forward has been developed that avoids the need for the top fund to actually hold a common share portfolio and, instead, to effectively “prepay” its obligations under the forward contract. This structure involves more tax complexities and may not be workable to achieve the objectives described above in all cases; nevertheless, it

can be a useful, and less costly, derivative instrument in certain circumstances.

This two-tier structure has been used to effectively offer underlying US investment funds that invest, for example, in mortgages, debt securities, mortgage-backed securities and asset-backed securities in which the income qualifies for the “portfolio interest” exemption from US withholding tax. It has also been used to effectively offer offshore funds not subject to entity level tax in their domicile and that invest in income-producing securities of any type. The structure is also well-suited to situations in which US or foreign managers wish to market offshore hedge funds to Canadian retail investors. Currently, there is increasing interest in the Canadian retail market for credit-related products, including, in particular, credit-linked notes, credit default swaps and other Collateralized Debt Obligation products. It can be expected that experienced US investment managers of these types of products will increasingly investigate the use of this structure to develop Canadian exchange-traded funds based on them.

Given that Ontario is a major jurisdiction for the sale of investment funds, US and other foreign investment advisors are increasingly seeking registration in Ontario as non-resident advisors to manage and advise these funds. Alternatively, these advisors may develop business relationships with Canadian entities established as management/promotion companies for exchange-traded funds.

A number of such specialized Canadian companies are registered as advisors in Ontario but will operate simply as administrative managers of the top funds. In these cases, the US or offshore advisor will act both as the investment advisor to the top fund, in the administration of the derivative contract, and as the investment advisor and portfolio manager of the underlying fund; in each case, the promoter/sponsor company will act as the manager of the vehicle, with the US or foreign investment manager acting as advisor in reliance on the previously mentioned exemption afforded under Ontario securities law.

Notes Linked to Underlying Investment Funds

Under Canadian securities laws, principal-protected deposit notes linked to underlying investment portfolios, funds, or baskets of securities or assets and issued by Canadian banks are not treated as securities for that purpose. Accordingly, these notes can be sold to retail investors without regard to the prospectus, dealer and advisor registration requirements of securities legislation but subject to specific disclosure requirements contained in Canadian bank legislation. In addition, Canadian securities laws provide prospectus and registration exemptions for debt securities of certain other types of Canadian financial institutions, including trust companies and insurance companies, for Schedule III banks (branches of foreign banks established in Canada

under Canadian bank legislation) and for certain Canadian and foreign governments and their agencies. Notes issued by Canadian issuers are not subject to the FIE rules, notwithstanding that the return on the notes may be linked to an underlying FIE.

Not unexpectedly, an active retail market exists in Canada for these “exempt” retail note products linked to underlying investment funds. In addition, a market is developing for non-principal-protected notes sold by Canadian financial institutions under medium-term note programs that are established under Canadian shelf prospectus offering procedures

and by US and other foreign financial institutions, either directly under the Canadian shelf prospectus procedures or under Canadian multi-jurisdictional offering rules that permit the use of US shelf prospectuses in Canada.

Creative structures have been developed to provide for “tax-advantaged” payment of returns under these notes. For the same reasons as described above, Canadian financial institutions and other issuers of these notes have actively sought out, and can be expected to continue to seek out, US and other foreign investment managers to design and manage attractive underlying investment funds or portfolios.



PATRICIA A. KOVAL, *TORYS LLP*

TEL: (416) 865-7356 • FAX: (416) 865-7380 • E-MAIL: pkoval@torys.com

Patricia practices in the area of corporate and commercial law, with primary emphasis on corporate finance, securities regulation, mergers and acquisitions, managed assets, derivatives and financial institutions.