PRIVATE EQUITY BULLETIN

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Registration Reform in Canada: Impact on Private Equity Fund Managers

Proposed registration reform in Canada will have a dramatic impact on private equity fund managers, investment advisers and dealers who are subject to the new requirements. Revised draft National Instrument 31-103 – Registration Requirements ("NI 31-103" or the "Revised Draft Instrument"), which was republished for comment earlier this year, is designed to harmonize and streamline the registration regime across Canada. The Revised Draft Instrument addresses concerns raised by a record number of commentators on the original draft which was published in February 2007.

The Revised Draft Instrument raises a number of questions with respect to the applicability of various provisions to private equity fund managers. Accordingly, private equity participants will need to examine their activities closely in order to determine whether registration is required in the new "investment fund manager" category, as an adviser or dealer, or some combination of the three. In the commentary accompanying the Revised Draft Instrument, the Canadian Securities Administrators (the "CSA") indicated (more than once) that with respect to private equity participants, the need for registration can only be assessed on a case-by-case basis.

As outlined in greater detail below, for the typical private equity fund structured as a limited partnership that is "actively involved" in managing the portfolio companies in which it invests, the general partner should not be subject to registration as an investment fund manager. Moreover, if the role of the general partner is to actively manage and develop private companies, registration as an investment adviser may not be required. **However, going forward, absent changes in the Revised Draft Instrument, it will be difficult for a general partner in a fundraising mode to avoid having to either register as an exempt market dealer or hire a dealer through which to distribute securities of the fund**.

The following provides a brief summary of the three potential registrations that could be required in relation to a private equity fund, as well as a flavour of some of the more onerous proposed requirements for registrants.

Investment Fund Managers

To Register, or Not to Register

One of the biggest changes contemplated by NI 31-103 is the introduction of a registration requirement for investment fund managers. While there is currently a registration requirement for advisers and dealers, the CSA has indicated that they wish to regulate investment fund managers directly, rather than impose restrictions on the funds themselves.

In order to determine whether registration in this category is required, private equity funds that are managed from within Canada must first determine whether or not they fall within the definition of an "investment fund". As described below, additional considerations apply to foreign-based private equity funds.

Under the *Securities Act* (Ontario) (the "Act"), the term "investment fund" includes both a "mutual fund" and a "non-redeemable investment fund". Many private equity funds would not fall within the definition of a "mutual fund" because they are not redeemable on demand. However, whether a private equity fund is a "non-redeemable investment fund" depends on whether or not it invests (i) for the purpose of exercising control of an issuer (other than another investment fund) or (ii) for the purpose of being actively involved in the management of an issuer in which it invests (other than another investment fund).

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If a private equity fund **does** in fact invest for the purpose of exercising control of its portfolio companies, or for the purpose of being actively involved in the management of such companies, it would **not** be a non-redeemable investment fund. Assuming it is also not a mutual fund, it would not be an investment fund, and its manager would **not** require registration as an investment fund manager. Neither NI 31-103 nor its Companion Policy provides any guidance with respect to the meaning of "active involvement" with an issuer.

If a private equity fund is structured or operated in such a way that it does constitute an investment fund, it would then be necessary to identify the manager of the fund who would require registration. An investment fund manager is defined in the Revised Draft Instrument as a person or company that is permitted to direct the business, operations or affairs of an investment fund. For example, the general partner of a limited partnership could fall within the definition of an investment fund manager, as could an external management company. Many private equity participants are involved in more than one fund. Requiring many affiliates to register as investment fund managers could be a cumbersome and expensive process. The Revised Draft Instrument is unclear, however, whether the management functions for a group of funds (such as affiliated general partners used for a family of limited partnerships under common management) could be contractually assigned to one registered entity. In a response to comments, the CSA suggested that exemptions from registration in such circumstances might be appropriate on a case-by-case basis.

Many investment funds sell their securities to investors in more than one Canadian jurisdiction. The CSA has confirmed that registration as an investment fund manager will only be required to be obtained in the jurisdiction in which the manager directs the fund, which will usually be the jurisdiction where the manager's head office is located.

For foreign private equity funds, the CSA's clarification means that unless the management of a fund is directed from inside Canada, investment fund manager registration will not be required for foreign private equity fund managers.

Obligations of Registered Investment Fund Managers

Registered investment fund managers will be required to comply with the comprehensive regime set forth in NI 31-103 governing their relationship with clients. As a preliminary matter, investment fund managers will be required to maintain minimum capital of $100,000, and insurance (which must be acceptable to the regulators) in the prescribed minimum amount. In the event an investment fund manager also requires registration as an adviser and/or dealer under NI 31-103, the capital and insurance requirements are not cumulative. A firm registered in more than one category must instead meet the highest requirements of its various categories.

Registered managers will also be subject to onerous compliance provisions, including conduct requirements relating to the handling of client assets, record-keeping, and creating and maintaining policies and procedures. Investment fund managers will, however, be exempt from the specific complaint handling requirements set out in the Revised Draft Instrument.

All investment fund managers will be required to appoint an "ultimate designated person" (UDP) and a "chief compliance officer" (CCO). The UDP is the CEO or senior officer in a similar capacity, responsible to lead the registrant's compliance efforts, while the CCO must be an officer whose role is to establish policies and procedures, monitor and assess compliance by the registrant and report to the UDP on specified matters. The CCO of an investment fund manager must meet specified proficiency requirements. For example, it is proposed one way the CCO may qualify is by having earned a CFA Charter or having a professional designation as a lawyer or accountant **and** having passed the Canadian Securities Exam and the PDO Exam. In addition, the CCO must have had prior experience in the industry, for example, through work at an investment fund manager for three consecutive years.

Registered investment fund managers will also be required to prepare and deliver to the applicable securities regulatory authorities annual audited and quarterly unaudited financial statements, calculations of excess working capital, and a description of any net asset value adjustment made during the relevant period.

Once NI 31-103 is effective, the requirement to register as an investment fund manager will apply six months after the effective date of the instrument.

Exempt Market Dealers

The Requirement to Register

Under existing securities legislation in Ontario, registration as a dealer is generally required to be obtained by persons who trade in a security. Exemptions from the registration requirement that would usually apply are removed for any person acting as a "market intermediary" which is generally a person engaged in, or holding themselves out as being engaged in, the business of trading securities. Under NI 31-103, registration as a dealer will only be required for persons or companies who are "in the business" of trading in securities as a principal or agent. The registration requirement will thus turn on whether or not the business trigger has been met.

In order to determine if registration as a dealer is required, participants must first determine if their activity involves trading in securities. "Trading" in securities would include sales of private equity fund securities, and any act, solicitation or conduct in furtherance of such a sale. If the activity involves trading, the Companion Policy to the Revised Draft Instrument indicates that the next step is to assess whether the activity is conducted as a business.

In general, the CSA considers that a person or company holding themselves out as being willing to engage in trading is sufficient to satisfy the business trigger, as it induces clients to rely on the person as a dealer. Similarly, engaging in practices similar to those used by registrants generally also reflects a business purpose. The CSA has also stated that acting in an intermediary capacity between a seller and a buyer of securities constitutes trading for a business purpose. Other factors to examine, but which are not necessarily determinative of whether a person is in the business of trading securities, includes the frequency with which the activities are conducted, whether compensation is received for the activities, or whether others are solicited in connection with the activity.

There are a number of comments in both the notice accompanying the Revised Draft Instrument and the Companion Policy that suggest the CSA will generally expect private equity participants to be registered as exempt market dealers in order to distribute securities of private equity funds. In response to a commentator, the CSA noted that under the current regime, while it depends on the circumstances, it is likely that most representatives of a private equity fund, including representatives of a general partner, currently require registration in Ontario (since such persons would be market intermediaries). The CSA continued to note that under the new regime, anyone in the business of trading would need to be registered. However, they also noted that depending on the circumstances, it is possible such representatives would not be in the business of trading. A commentator had suggested, for example, that arguably private equity funds were in the business of managing assets, rather than in the business of trading in securities. The CSA indicated that the business trigger is very fact-specific, but that they may issue more specific guidance with respect to private equity in the future.

Based on the foregoing factors, we would expect that anyone involved in the sale of private equity fund interests to investors, whether undertaken by the general partner of a partnership or an external company, would often pass the business trigger test, requiring registration as a dealer. In such circumstances the exempt market dealer category (rather than registration as a full investment dealer), might be appropriate.

Obligations of Exempt Market Dealers

In Ontario and in Newfoundland and Labrador, persons whose trading activities are limited to private placements are currently often registered as "limited market dealers". NI 31-103 replaces this category with that of an exempt market dealer. An exempt market dealer may trade in specific securities, including those distributed under an exemption from the prospectus requirements (e.g. to accredited investors).

Unlike limited market dealers, exempt market dealers will be subject to proficiency, capital and insurance requirements. Exempt market dealers must also designate a UDP and a CCO. To the extent an exempt market dealer does not handle, hold or have access to client assets (including cheques), the capital and insurance requirements will not apply. The extent of the compliance regime that will be applicable to exempt market dealers will differ depending on whether the dealer handles, holds or has access to client cash or assets, or if they are dealing with "permitted clients", a sub-set of those persons

deemed to be accredited investors. Permitted clients will include financial institutions, corporations with shareholder's equity of at least $100 million on a consolidated basis, and individuals with more than $5 million in financial assets before taxes but net of any related liabilities. For example, the suitability obligation will not apply to exempt market dealers when dealing with permitted clients, nor will the know-your-client, account opening information and complaint handling requirements of NI 31-103. Regardless of whether an exempt market dealer deals only with permitted clients, they will be required to deliver to the regulators audited annual and quarterly unaudited financial statements and reports on excess working capital. Exempt market dealers that do not have access to client assets will be exempt from the requirement to deliver annual audited statements, but will be required to deliver certified quarterly unaudited statements.

It is noteworthy that the proposed regime for dealers who restrict their business to the exempt market will differ in British Columbia and Manitoba. These two jurisdictions are not proposing to require registration as an exempt market dealer for persons or companies not otherwise registered in Canada who restrict their activities solely to each of those provinces.

Investment Advisers

As is currently the case under securities legislation in Ontario, persons who are in the business of advising in securities will be required to register as an adviser under NI 31-103.

Under the Act, an adviser is a person or company engaging in (or holding itself out as engaging in) the business of advising others as to the investing in or the buying and selling of securities. The manager of a private equity fund might thus require registration as an adviser.

The Companion Policy does provide helpful guidance aimed at private equity funds with respect to adviser registration. As a general matter, the same factors relevant to determining whether or not a person is in the business of trading are also relevant with respect to whether or not a person is in the business of advising.

The CSA noted that the expectations and reliance of investors may be relevant when applying these business trigger factors to venture capital and private equity. The Companion Policy examines whether a general partner of a limited partnership would have to register as an adviser, and indicates the results will depend on the application of the business trigger factors, the types of services provided by the general partner to the limited partnership, as well as the expectations of the limited partners. For example, if the role of the general partner is to select small private companies to actively manage and develop, registration as an adviser may not be required. If however, the limited partners rely on the general partner for its expertise in selecting securities and deciding when to buy and sell them, the CSA might require the general partner to register as an adviser. The CSA was careful to point out that the legal entity used by a fund will not be determinative.

It is essential therefore, to consider participants' roles with respect to a private equity fund to determine whether adviser registration would be expected to be obtained.

Registered advisers will be subject to the compliance regime of NI 31-103. For example, all advisers will be required to appoint a UDP and a CCO, although the proficiency requirements for CCOs of portfolio managers and investment fund managers differ.

Next Steps

The CSA is continuing to accept comments on the Revised Draft Instrument until May 29, 2008, and we encourage all affected parties to consider providing input on how the proposals will affect their business. We understand that Canada's Venture Capital & Private Equity Association (the "CVCA"), which represents the private equity industry in Canada, has met with the Ontario Securities Commission and expressed a number of concerns with the impact of NI 31-103 on the industry. We understand that the CVCA will be making further written submissions to the CSA and the Ontario

government by the May 29th deadline for comments on the Revised Draft Instrument. Ideally, the CSA would provide additional commentary directed specifically at private equity participants when NI 31-103 is republished (and provide relief where appropriate from the additional regulatory burden imposed by NI 31-103).

For advice on how to make your views known to the CSA or for more information about the new proposed requirements, please contact your McMillan Binch Mendelsohn lawyer or one of the lawyers listed below[1].

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[1] Additional information with respect to the Revised Draft Instrument may be found in our Public Markets Bulletin entitled "Reforming Registration Reform: Canadian Securities Administrators Issue Second Draft of National Instrument 31-103" and "Reforming Registration Reform: Further Information for Portfolio Managers and Investment Fund Managers" at www.mcmbm.com.

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