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Registration Requirements of Venture Capital and Private Equity Fund Managers in Canada: A Favourable Regulatory Framework

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LAVERY: A LEADER IN MONTREAL IN THE PRIVATE EQUITY, VENTURE CAPITAL AND INVESTMENT MANAGEMENT INDUSTRY

Creating and setting up private equity and venture capital funds are complex initiatives requiring specialized legal resources. There are very few law firms offering such services in Quebec. Lavery has developed enviable expertise in this industry by working closely with promoters to set up such structures in Canada and, in some cases, the United States and Europe, in conjunction with local firms. Through Lavery's strong record of achievements, the firm sets itself apart in the legal services market by actively supporting promoters, managers, investors, businesses and other partners involved in the various stages of the implementation and deployment of private equity and venture capital initiatives.

The U.S. House of Representatives passed a bill in December 2013 that would exempt many private equity fund advisers in the United States from the provision in the *Dodd-Frank Wall Street Reform and Consumer Protection Act* (the "Dodd-Frank Act") that requires advisers with more than $150 million in assets under management to register with the U.S. Securities and Exchange Commission (the "SEC"). The bill's passage into law remains, however, uncertain. As a result, most private equity fund advisers in the United States remain under the oversight of the SEC.

Canada, in contrast, remains one of the very few remaining jurisdictions where most private equity fund managers do not have to register with any securities regulator. When the Canadian Securities Administrators (the "CSA") proposed the adoption of National Instrument 31-103 – Registration Requirements in 2007, many feared that this would change. A record number of comments made on the original draft in response to such changes led the regulators to clarify, in the final version of the policy adopted along with the new instrument, that the intention of the CSA was not to subject typical private equity funds to such requirements.

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REGISTRATION AS A PORTFOLIO MANAGER

The CSA indicates that venture capital and private equity funds (and their general partners and managers) (collectively, the "VCs") are not required to register as a portfolio manager if the advice provided to the fund (and indirectly to the GUILLAUME LAVOIE glavoie@lavery.ca ANDRÉ VAUTOUR avautour@lavery.ca investors of the fund) in connection with the purchase and sale of securities is incidental to their active management of the fund's investments (notably as a result of the VC having representatives sitting on the boards of directors of the portfolio companies in which they invest) and if the VCs do not solicit clients on the basis of their securities advice. It must be also clear that the expertise of the manager of the VC is sought in connection with the management of the portfolio companies and that its remuneration is connected to such management and not to any securities advice it might be considered to be giving to the fund and its investors.

REGISTRATION AS AN INVESTMENT FUND MANAGER

VCs are typically not considered to be mutual funds because of the fact that their units or shares are not redeemable on demand. VCs that have redemption provisions in their organizational documents will typically have a series of important redemption restrictions that prevent them from being considered redeemable on demand. The CSA generally takes the view that where an investment fund allows its investors to redeem the securities they own in the fund less frequently than once a year, the fund does not provide an "on demand" redemption feature.

Further, VCs are generally involved in the management of the companies they invest in. Such involvement can take the form of a seat on a board of directors or a direct involvement in the material management decisions or in the appointment of managers of such companies. As a result, they will not be considered to be "non-redeemable investment funds" as defined in Canadian securities legislation.

A VC that is neither a mutual fund nor a non-redeemable investment fund will not be considered to be an "investment fund" for the purposes of Canadian securities legislation. Consequently, its manager will typically not have to register as an investment fund manager.

REGISTRATION AS A DEALER

With regards to the dealer registration requirement, one must determine if the manager can be considered to be "in the business" of trading in securities. "Trading in securities" includes the sale of securities of the fund but also the simple act of soliciting potential investors on behalf of the VC. Determining factors in making such assessment will be (i) whether the manager is carrying on the activity of trading securities with repetition, regularity or continuity, (ii) whether it is being, or expected to be, remunerated or compensated for such activity and (iii) whether it is directly or indirectly soliciting investors. Based on these factors, most VCs will not normally be considered to be in the business of trading in securities.

VCs solicit investors to invest in the fund, but this will typically be done for a limited period of time, without repetition, regularity or continuity and will normally be incidental to the involvement of the manager in the management of the portfolio companies. Further, the manager will typically not receive any compensation for its fund raising. Its compensation will rather relate to the management of the portfolio investments themselves in the form of a management fee and of a carried interest in the profits generated by these investments. These factors will normally allow the VC to be able to consider that it is not in the business of trading in securities.

VCs that have a dedicated sales/marketing team or that have formed funds with open commitment and investment periods that regularly raise capital and invest such capital in portfolio companies should, however, be careful as to whether this reality may cause them to be characterized as being in the business of trading in securities. Given the ambiguity of the law in this respect and that such

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determination is fact-specific, some institutional investors may require that the promoter of the fund registers as an exempt-market dealer even when an argument can be made that no registration is required.

In the context of the foregoing regulatory framework and in light of the growing Canadian private equity market, Canada can be an interesting market for private equity fund managers to launch a first venture capital or private equity fund without having to immediately bear those expenses mandated by the registration process with a securities regulatory authority.

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