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U.S. SECURITIES LAW CONSIDERATIONS IN STRUCTURING A CROSS-BORDER FUND

Hodgson Russ Canada-U.S. Cross-Border Alert
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Practices & Industries

Canada-U.S. Cross-Border

Securities Regulation & Corporate Compliance

If you operate a Canadian fund and are considering taking on some United States investors, you may have considered with some trepidation whether such a step requires registering with the Securities and Exchange Commission ("SEC") under the United States Investment Advisers Act of 1940 (the "Advisers Act"), registering as an "investment company" under the United States Investment Company Act of 1940 (the "Investment Company Act"), or what exemptions you might use to sell securities under the United States Securities Act of 1933 (the "Securities Act"). This primer may clear up some of the basic questions on these interlocking sets of securities considerations and serve as a starting point for further discussion.

Securities Act Considerations

Many cross-border funds are structured as limited partnerships and the sale of the limited partnership interests to United States investors will need to be structured to fit within an exemption from the registration requirements of the Securities Act. For an overview of the most common exemptions, please refer to the following:

Structuring a Cross-Border Securities Offering: Common U.S. Exemptions From Registration: Hodgson Russ LLP

The vast majority of private cross-border funds will sell limited partnership interests to select U.S. investors in a private placement conducted pursuant to Rule 506(b) of Regulation D under the Securities Act. Such purchasers are generally all "accredited investors" and a Form D must be filed with the SEC within 15 days of the first sale of securities. If the fund is paying any sort of sales commission or finder's fee to a third party for soliciting investors, the recipients of such payments must be registered broker dealers. For an outline of the U.S. law on finders and related payments, please refer to the following:

Finders May Not Be Keepers: Traps for the Unwary in Awarding Transaction-Based Compensation: Hodgson Russ LLP

Advisers Act Considerations

Money managers, investment consultants and financial planners are regulated in the United States as "investment advisers" under the Advisers Act and/or similar state statutes. Formally, a person or firm comes under the purview of the Advisers Act if it

(1) is engaged in the business of (2) providing advice to others or issuing reports or analyses regarding securities (3) for compensation.

By definition, an investment adviser provides advice on the purchase and sale of *securities*. If the fund invests in securities, then the fund's sponsor would in most cases be deemed to be providing advice – to the fund as its client – about the purchase and sale of those securities. Also, if an adviser's "securities portfolios" meet certain assets under management (AUM) thresholds– i.e., generally over $100 million AUM, or $150 million AUM if the adviser is managing only private funds – registration under the Advisers Act is required. If those AUM thresholds are not met, then a state investment adviser registration may still be required. It should be noted that the definition of a "security" may be quite broad in this context. A fee simple interest in real estate (e.g., 100% ownership of an office building) may not be commonly thought of as a security. However, interests in limited partnerships that in turn hold title to real estate, or an "investment contract" such as that found in the seminal United States Supreme Court *SEC vs. Howey* case could turn the ownership of such an asset by fund investors into ownership of "securities" depending on the circumstances.

Firms that are registered under the Advisers Act are subject to a broad fiduciary duty to their clients rather a comprehensive regulatory regime, although they must comply with SEC rules regarding anti-fraud, advisory fees, restrictions on advertising, custody of client assets, proxy voting and recordkeeping as well as adherence to an internal compliance program maintained by a Chief Compliance Officer (CCO), which includes a written code of ethics. Depending on the nature of your cross-border business, you may wish to stay exempt from the requirements of the Advisers Act, or alternatively, explore one of the routes to formally register with the SEC.

Even if you have U.S. clients, you may qualify for a *de minimis* exemption from registration under the Advisers Act, if you:

1. Have no place of business in the United States;
2. Have, in total, fewer than 15 clients in the United States (including U.S. investors in private funds advised by the adviser);
3. Have aggregate assets under management attributable to such clients and investors of less than U.S.$25 million; and
4. Do not hold yourself out to the public in the United States as an investment adviser.

As long as all four prongs of the test above are satisfied, you may conduct your advisory business with existing U.S. clients on the basis of this exemption from registration. If the *de minimis* threshold is crossed, it may be time to consider registering as an investment adviser. For more details on this process, please consider the following:

To Register or Not to Register: A Primer for Ontario Investment Advisers: Hodgson Russ LLP

Investment Company Act Considerations

The Investment Company Act is a comprehensive regulatory regime regulating the business activities of "investment companies," which require registration with the SEC and are subject to a host of restrictions on their activities, including the types of contracts they are permitted to enter into. Canadian practitioners typically think of U.S. investment companies as akin to Canadian mutual funds; however, the extremely broad wording of the Investment Company Act potentially

implicates the activities of a variety of enterprises, some of which do not consider themselves remotely investment companies at all. We refer to such entities as an "inadvertent investment company." The potential consequences of being classified as an investment company are severe and include potential rescision of contractual commitments, private rights of action, and exposure to SEC sanctions.

Section 3(a)(1)(A) of the Investment Company Act defines an investment company as an issuer that is or holds itself out as being engaged primarily in an investment company business; Section 3(a)(1)(B) of the Investment Company Act defines an investment company as an issuer that is a face-amount certificate company; and Section 3(a)(1)(C) of the Investment Company Act defines an investment company as an issuer that holds more than 40 percent of its assets (other than cash and government securities) in investment securities.

Funds that transact in traded securities may be clearly captured under Section 3(a)(1)(A) of the Investment Company Act, but it is under Section 3(a)(1)(C) where the "inadvertent investment company" arises if it owns or proposes to acquire, investment securities having a value exceeding 40 percent of the value of its total assets. Due to the extremely broad conception of a "security," fund assets consisting of minority interests in operating companies and limited partnership interests generally could all constitute "securities" and subject the fund to regulation as an investment company under the Investment Company Act.

The Private Fund Exemption

Whether your fund is possibly implicated by Section 3(a)(1)(A) or 3(a)(1)(C) of the Investment Company Act, the first step for many funds is finding an appropriate exemption from the often draconian provisions of the statute.

Section 3(c)(1) of the act excepts from the definition of investment company any issuer whose outstanding securities (other than short-term paper) are beneficially owned by not more than 100 persons and which is not making and does not presently propose to make a public offering of its securities. Foreign investment vehicles may generally rely on the definition of "U.S. Person" in Rule 902(k) of Regulation S under the Securities Act to determine whether an investor must be counted against the 100 investor limit in Section 3(c)(1).

In order to take advantage of the Section 3(c)(1) exception, no more than 100 United States natural persons may beneficially own the fund's outstanding securities (applying a look-through if any of the fund's security holders are not natural persons), and the fund may only raise capital from such persons under an exempt offering or private placement (see section above regarding the Securities Act).

Section 3(c)(7) of the Investment Company Act permits a private fund to have an *unlimited* number of investors as long as they are all "qualified purchasers" as defined in Section 2(a)(51) of the Investment Company Act – a much higher standard of net worth than the "accredited investor" standard for Regulation D offerings as discussed above.[1] Most qualified institutional buyers (QIBs) under Rule 144A of the Securities Act are also likely to meet the standards for being qualified purchasers, but the definitions of the two terms are different in certain important respects. Again, foreign investment vehicles may generally rely on the definition of "U.S. Person" in Rule 902(k) of the Securities Act to determine if such investors are qualified purchasers in the case of an issuer relying on Section 3(c)(7).

In summary, a Canadian private fund seeking an exemption under the Investment Company Act should ensure that all U.S. holders in the fund either (a) number no more than 100 in the aggregate (applying a look-through standard) or (b) are composed exclusively of "qualified purchasers". It is good practice for a fund issuer engaging in an offering of this sort to include in its charter documents a right to redeem on very short notice the holdings of any investor that is subsequently determined to be a U.S. person, if such investor would put the fund offside on either standard.

Section 3(c)(5)(C) – Special Considerations for Real Estate Funds

In some cases, where a real estate fund is investing in securities (and therefore needs to find an exclusion from registration under the Investment Company Act) but does not want to be bound by the requirements of the Section 3(c)(1) (100 investor limit) or Section 3(c)(7) (investors must be qualified purchasers) exceptions from investment company status, it may be able to rely on the Section 3(c)(5)(C) exception in the Investment Company Act. This exclusion may apply where the fund is "primarily engaged in … purchasing or otherwise acquiring mortgages and other liens on and interests in real estate." To satisfy the primarily engaged requirement of the Section 3(c)(5)(C) exception, the fund (1) must invest at least 80% of its assets as follows: (A) not less than 55% thereof in certain enumerated "Qualifying Interests" (in general, these must be actual interests in real estate or be a loan or lien backed by real estate); plus (B) up to 25% thereof in "real estate related assets"; and (2) may invest up to 20% of its assets without restriction.

Fund Manager Compensation

A fund that is not investing in "securities" or a fund that does not need to register under the Advisers Act is not subject to the regulatory restrictions imposed by the Advisers Act in connection with the compensation structure for the fund manager. For example, a fund manager managing a pure real estate fund may charge all sorts of management, acquisition, development fees with a distribution-based carried interest with performance hurdles, so long as disclosed to, and acceptable to, the fund investors. However, once subject to Advisers Act registration, the fiduciary duties under the Advisers Act will come into play. With some exceptions, the Advisers Act prohibits advisers from entering into a contract with a client that varies with the adviser's success in managing the client's money, *i.e.*, a performance fee based on a share of the capital gains or appreciation of a client's funds. There are certain exceptions to this rule, for instance, such a contract is permissible if it is entered into with certain "qualified clients," including funds made up exclusively of "qualified purchasers" discussed above.

Tax Considerations

Although fund tax considerations are generally beyond the scope of this article, it should be noted that many cross border funds that invest in non-U.S. securities or passive investments may be classified as a "Passive Foreign Investment Company" ("PFIC") under applicable tax rules and U.S. holders of fund interests may become subject to the PFIC tax regime as a result. The PFIC regime imposes obligations for U.S. persons to report taxable income and comply with certain reporting requirements.

A PFIC is a non-U.S. corporation where, in any year, either (a) 75% or more of the non-U.S. corporation's gross income is passive income; or (b) 50% or more of the non-U.S. corporation's assets are passive assets. "Passive income" includes dividends, interest, and gains from the sale or exchange of investment property and rents and royalties other than rents and royalties which are received from unrelated parties in connection with the active conduct of a trade or business.

The PFIC regime aims to discourage U.S. persons from forming a foreign corporation and using that company to invest in primarily passive investments, thereby attempting to shift income out of the U.S. federal tax net. Potentially harsh tax results will ensue for such U.S. persons that may increase that investor's total U.S. federal income tax liability, not simply affecting the overall timing of when U.S. federal income tax is due. Specifically, if a U.S. person is treated as owning an interest in a PFIC, that person may be subject to special tax and interest charges upon receipt of an 'excess distribution,' which consists of certain distributions from, and all gain from the disposition of stock in, the PFIC. This special tax and interest charge approximates the U.S. federal income tax that would have been payable if the foreign corporation had distributed all of its income every year. The calculation of excess distributions is performed annually and can be quite complex. Alternatively, that person *may* be able to avoid the application of the excess distribution rules by making a special election to include amounts in income each year, regardless of whether or not the PFIC makes a distribution in that year. However, the making of such election will require particularized information from the fund, causing the fund to incur accounting and reporting costs to enable this tax benefit on a holder's behalf. Funds expanding to the U.S. are encouraged to consider their potential PFIC status and to include a disclaimer in their subscription materials to ensure that no U.S. investor is potentially caught off-guard by these specific rules.

Regulatory Considerations

The Employee Retirement Income Security Act of 1974 (ERISA) bears on the structuring of a fund if 25% of the investors in any class of equity in the fund are owned by "benefit plan investors" (as defined in ERISA). If the fund meets the 25% threshold, the investment manager will be required to act as a fiduciary of the benefit plan investors and could be prohibited from having the fund make certain types of investments. As such, cross-border funds often limit investment by benefit plan investors or prohibit participation altogether.

Section 13 Reporting

For funds or investment advisers managing discretionary accounts that invest in publicly traded securities, please consider the following summary of Section 13 reporting:

SEC Reporting Obligations under Section 13 of the Exchange Act – A Primer for Investment Managers: Hodgson Russ LLP

For any questions you have regarding these matters, please contact Timothy Ho (416.595.2673).

[1] A "qualified purchaser" is defined in the rule by reference to section 2(a)(51) of the Investment Company Act, which generally defines a "qualified purchaser" to include: (i) a natural person who owns not less than $5 million in investments; (ii) a trust that meets certain requirements; and (iii) any person (including an investment adviser) who in the aggregate owns and invests on a discretionary basis not less than $25 million in investments.