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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.

PROPOSED GENERAL ANTI-TREATY SHOPPING RULE: PRIVATE INVESTMENT FUNDS WILL NEED TO PLAY IT SAFE

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Following the recent public consultations held by the federal government on the issue of treaty shopping, the 2014 Budget proposes to implement in the Canadian domestic law a general anti-treaty shopping rule ("**GATSR**") which private investment funds investing in Canada ("**Funds**") may have to deal with.

Treaty shopping refers to a situation where, for example, a non-resident person who is not entitled to benefits under a Canadian tax treaty uses an entity in a country with which Canada has concluded a tax treaty and, to obtain Canadian tax benefits, earns or realizes income sourced in Canada indirectly through that entity.

The GATSR would probably be integrated into the *Income Tax Conventions Interpretation Act*. Its application would result in denying in whole or in part the benefits claimed pursuant to a tax treaty.

The GATSR provisions would provide for the following items:

- **Main purpose provision:** Subject to the relieving provision, the purpose of the GATSR would be to deny the benefit of a tax treaty to a person where it is reasonable to conclude that one of the main purposes of the transaction or series of transactions is to allow that person to obtain the benefit.
- **Conduit entity's rebuttable presumption:** It would be presumed that one of the main purposes of the transaction or series of transactions is to obtain a benefit pursuant to such a treaty if the income in question is primarily used to pay, directly or indirectly, an amount to another person (such as a limited partner of a Fund) who would not have been entitled to an equivalent or more favourable benefit had that person received directly the income in question.
- **Safe harbour's rebuttable presumption:** Subject to the rebuttable presumption of use of a conduit entity, it would be presumed that none of the main purposes for undertaking a transaction was for someone to obtain a benefit under a tax treaty if, as the case may be:
  - the person carries on an active business, other than managing investments, in the foreign treaty country and, where the income in question is derived from a related person in Canada, the active business is substantial compared to the activity carried on in Canada by such related person;
  - the person is not controlled, *de jure* or *de facto*, by another person who would not have been entitled to the benefit had that person directly received the income in question;
  - the person is a corporation or trust listed on a recognized stock exchange.

- **Relieving provision:** The Minister of National Revenue ("Minister") would, at his discretion, allow the grant of the benefit, in whole or in part, when circumstances reasonably justify it.

Some examples of application of the GATSR suggest that a Fund may be targeted by the new rule. A fund which is set up as a limited partnership generally relies on a holding corporation which may be considered by the Minister as a conduit corporation pursuant to the GATSR. Funds should not assume that the legislator will provide relieving transitional rules for current structures, but rather consider right now the implementation of mechanisms to avoid or reduce the effects of the GATSR.

REGISTRATION REQUIREMENTS OF VENTURE CAPITAL AND PRIVATE EQUITY FUND MANAGERS IN CANADA: A FAVOURABLE REGULATORY FRAMEWORK

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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.

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 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 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.

BILL 1: NEW REQUIREMENTS FOR PUBLIC CALLS FOR TENDERS

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The *Integrity in Public Contracts Act*, also referred to as Bill 1, has been assented to on December 7, 2012. This Act imposes new requirements on public contracts tenderers. Managers of infrastructure funds have to be familiar with the rules under this Act as they most likely will have to deal with them in the context of an investment or a project involving a public body.

AMENDMENTS TO THE ACT RESPECTING CONTRACTING BY PUBLIC BODIES

The *Act Respecting Contracting by Public Bodies* ("**ARCPB**") determines the conditions applicable to contracts between a public body and private contractors involving an expense of public funds. The ARCPB applies to supply contracts, to services contracts and construction contracts entered into with these public bodies, as well as to public private partnership agreements entered into as part of an infrastructure project.

Bill 1 amended the ARCPB in order to reinforce integrity in public contracts and control access to these contracts. It further increases the number of public bodies covered by the ARCPB by adding entities such as Hydro-Québec, Loto-Québec and the SAQ.

The amendments provides for the implementation of a system to verify that enterprises wishing to enter into contracts with public bodies or municipalities meet the required conditions as regards integrity. Therefore, an enterprise wishing to enter into a contract (or a related subcontract) with a public body for an amount equal to or greater than a threshold determined by the government is required to obtain an authorization from the Autorité des marchés financiers (the "**AMF**").

The enterprise must generally have obtained this authorization by the date it files its bid. In the case of a consortium, each member enterprise must be individually authorized by that date. An authorization must be maintained throughout the performance of the public contract or subcontract. An authorization is valid for a period of three years and must be renewed upon expiry. The AMF keeps a public register of enterprises holding an authorization to enter into a contract or a subcontract with public bodies. These rules also apply to contracts awarded by towns and municipalities.

CONDITIONS FOR OBTAINING AN AUTHORIZATION

An application for an authorization must be made to the AMF. The contractor must provide with his application an attestation from Revenu Québec, stating that the enterprise has filed the returns and the reports required under tax laws and that it has no overdue account payable to the Minister of Revenue. Lastly, the enterprise must not have been refused an authorization or have had its authorization revoked in the preceding 12 months.

Upon receipt of an application for authorization from an enterprise, the AMF sends to the permanent anti collusion squad (Unité permanente anticorruption or "**UPAC**") the information obtained in order for the UPAC to make the verifications it deems necessary in collaboration with the Sûreté du Québec, Revenu Québec, the Régie du bâtiment du Québec and the Commission de la construction du Québec ("**CCQ**"). The UPAC sends to the AMF a report analysing the enterprise compliance with the integrity requirements. The AMF renders a decision on the application for an authorization.

DECISION OF THE AMF

Bill 1 provides for mandatory and discretionary grounds for refusal. Thus, the fact, for an enterprise or related person, of having been found guilty, within the five preceding years, of any offence under various provincial or federal laws listed in Schedule I to this Act will result in the enterprise being automatically denied its application for an authorization. The offences listed in Schedule 1 mainly relate to criminal law and tax laws.

If the enterprise applying for an authorization, or if any of its shareholders holding 50% or more of the voting rights attached to the shares of the enterprise, or any of its directors or officers has, in the preceding five years, been found guilty of an offence listed in such Schedule I, the AMF will refuse to grant or to renew an authorization. The AMF may even revoke an authorization if an enterprise or any of its related persons is subsequently found guilty of such an offence.

Furthermore, if an enterprise has, in the preceding five years, been found guilty by a foreign court of an offence which, if committed in Canada, could have resulted in criminal or penal proceedings for an offence listed in Schedule I, the AMF will automatically deny the issuance or renewal of an authorization. Lastly, an enterprise found guilty of certain offences

described in electoral laws or who, in the preceding two years, has been ordered to suspend work pursuant to a decision of the CCQ will also be denied its application for an authorization.

Furthermore, the AMF may also, at its sole discretion, refuse to grant or to renew an authorization or even revoke an authorization already granted to an enterprise if the enterprise fails to meet the high standards of integrity that the public is entitled to expect from a party to a public contract or subcontract. In this respect, the AMF, following an investigation by the UPAC, will review the integrity of the enterprise, its directors, partners, officers or shareholders as well as that of other persons or entities that have direct or indirect legal or de facto control over the enterprise (a "*related person*"). To that end, the AMF may consider certain elements which are described in the ARCPB, particularly the fact that the enterprise or a related person maintains connections with a criminal organization, has been prosecuted, in the preceding five years, in respect of certain offences or has repeatedly evaded or attempted to evade compliance with the law in the course of the enterprise's business. The AMF will also consider the fact that a reasonable person would conclude that the enterprise is the extension of another enterprise that would be unable to obtain an authorization or that the enterprise is lending its name to another enterprise that would be unable to obtain an authorization.

CONSEQUENCES OF FAILURE TO BE AUTHORIZED

A contractor or subcontractor whose authorization expires, is revoked or denied upon application for renewal is deemed to have defaulted on the public contract or subcontract to which it is a party. In such a case, the enterprise must cease its work, except for contracts where only the obligation to honour the contractual guarantees remains. However, the enterprise may continue to perform the contract if the public body applies to the Conseil du trésor for permission for the continued performance of the contract or subcontract for reasons of public interest and the Conseil du trésor grants such permission. The Conseil du trésor may subject the permission to certain conditions.

TRESHOLDS AND APPLICATION

Upon coming into force, the Act provided that the new provisions would apply to public contracts and subcontracts that involve an expenditure equal to or greater than $40,000,000. This threshold has been lowered to $10,000,000 in December 2013.

Furthermore, the Act provides that regardless of the amount of the contract, the government may, before March 31, 2016, determine that the rules requiring an authorization apply to public contracts or subcontracts even if they involve a public expenditure amount of less than this threshold or that such rules apply to a category of contracts other than those currently regulated pursuant to the ARCPB. In such a case, the government may stipulate special terms for the applications for authorization that enterprises must file with the AMF in respect of such contracts.

Lastly, the Act provides that the government may still before 31 March 2016, require enterprises that are parties to public contracts currently in process to file an application for authorization within the time it specifies. This provision is not limited to the contracts currently in process at the time Bill 1 comes into force and may therefore affect any contract in process before March 31, 2016.

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