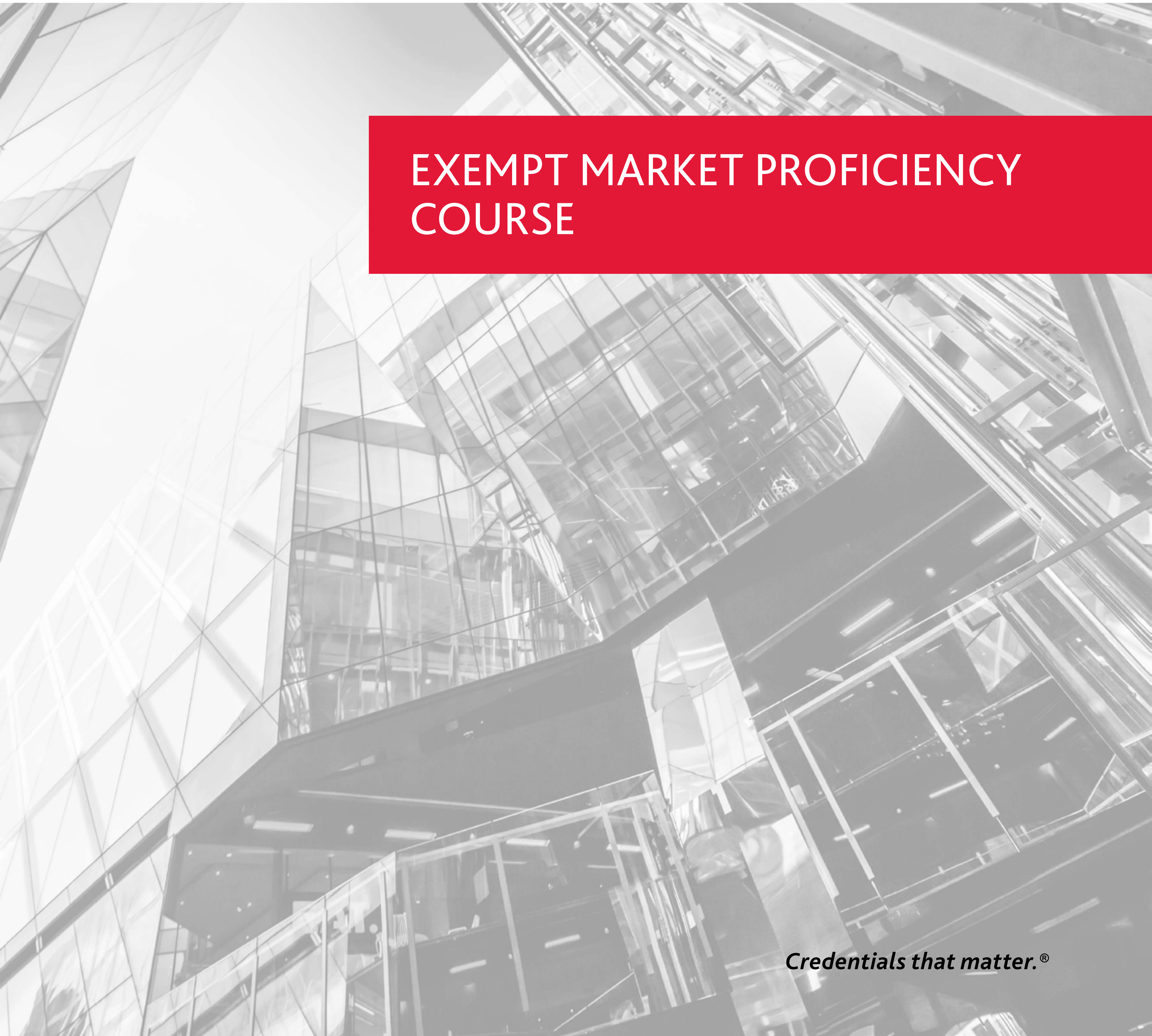
Canadian Securities Institute

EXEMPT MARKET PROFICIENCY COURSE



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UNIT 1

OVERVIEW OF THE CAPITAL MARKETS

INTRODUCTION

This unit will introduce you to the concept of investing and the Canadian capital markets. It will also define the exempt market and explain how it fits into the broader capital markets.

After this introduction, you will be ready to explore specific exempt products in more detail.

This unit takes approximately 1 hour and 15 minutes to complete.

Lessons in this unit:

1. Investment Capital
2. The Public Capital Markets
3. Private or Exempt Capital Market

Investment Capital 1

CONTENT AREAS

- What is Investment Capital?
- The Financial Market
- Demand for Investment Capital
- How Companies Raise Capital
- Financial Intermediaries
- Types of Financial Instruments

INTRODUCTION

In this lesson you will learn about what it means to invest and why it is important, investment capital and its role in the financial markets, and the general investment characteristics of each type of security. Before discussing investments with clients, you should understand the purpose of investing and about the key features of the different types of securities in relation to your clients' investment needs and objectives.

This lesson takes 20 minutes to complete.

LEARNING OBJECTIVES

At the end of this lesson, you will be able to:

1 | Define investment capital.

2 | Understand the role of capital in financial markets.

3 | Describe how corporations raise capital.

4 | Describe the different types of financial instruments.

WHAT IS INVESTMENT CAPITAL?

Capital is wealth in the form of money or assets of an individual, organization, or nation which is available for development or investment.

A nation's wealth is connected to the quantity and quality of its capital. The more capital a country has, the higher its productivity, competitiveness, and incomes are likely to be. A country builds capital by saving. To save means consuming less than total income. The remainder is available for various purposes such as reducing debt or investing in new assets.

Being able to convert idle savings into investment capital is critical for the long run prosperity of an economy. By lending money to buy new housing, banks help local infrastructures grow and meet the needs of an expanding population. The same is true when governments borrow money to build hospitals and roads or when corporations issue securities to finance expansion of their operations. Without access to investment capital, governments and companies are limited by the amount of capital they can access internally.

THE FINANCIAL MARKET

Providers of capital (lenders) and users of capital (borrowers) participate in the financial market including governments, corporations, and investors.

Financial markets serve borrowers and lenders by:

- channeling funds from lenders to borrowers
- facilitating the timing of purchases through borrowing and lending
- providing a mechanism for government policy

For example, if a government needs to borrow funds, it issues bonds. Investors purchase the bonds and act as lenders to the government.

Corporations are major users of investment capital. Corporations raise funds for a number of reasons; the main impetus is to fuel expansion. Significant changes to technology and the globalization of markets provide big incentives for corporations to acquire new equipment. A company's retained earnings may not always suffice. Or, a company may see a greater benefit in using financial markets for current needs, saving retained earnings for other uses or for a business downturn. Corporations also participate in the financial market through mergers and acquisitions in order to take over competitors or to access new markets.

DEMAND FOR INVESTMENT CAPITAL

The demand for investment capital has been growing rapidly in recent years, in part because of the rise of new markets and emerging economies such as Brazil, Russia, India, China and South Africa (also known as BRICS). Long periods of low interest rates and high share values meant more and more corporations have gone directly to the markets to finance their projects when retained earnings and/or bank financing have been unavailable or unattractive.

HOW COMPANIES RAISE CAPITAL

Corporations can raise money in a number of ways. They may issue stock to raise capital; however, doing so spreads ownership of the corporation across a wider group—the shareholders. They may also choose to use long-term debt instruments, such as bonds and debentures, to raise capital. Bonds are backed by assets owned by the issuer and, therefore, may be less risky. Debentures are similar to bonds, except that they are generally unsecured. The ownership structure of a corporation is unchanged by debt issues, but issuing debt can be a negative signal about a firm's financial health. A large debt burden restricts a corporation's ability to raise more capital in the future. It also increases the risk of default, forcing the company to pay higher interest rates than similar companies with less debt. Corporations therefore strive for a healthy mix of debt and equity securities. Let's consider an example of an auto parts producer known as CarKing.

EXAMPLE

Rising demand for its product has motivated CarKing to build a new factory. To do so, it must raise at least $15 million to finance the facility. Simply issuing bonds to cover the costs would put current outstanding debt at a very high level compared to revenue. CarKing decides to offer 100,000 new shares at $50 each into the market, for a total of $5 million (disregarding fees). The rest of the project is financed through a 30-year bond issue, with a 7% annual interest paid semi-annually. This scenario should generate enough capital to build the factory and leave the company's debt burden relative to its shareholders' equity within acceptable limits in line with its market sector.

Corporations also issue short-term debt instruments to finance their day-to-day needs:

- commercial paper, which is unsecured short-term debt
- bankers' acceptances, which is short-term debt guaranteed by a bank

FINANCIAL INTERMEDIARIES

Funds can flow from lenders to borrowers in two ways:

- directly
- indirectly

DIRECT FINANCING

In the case of direct financing, a borrower deals directly with the lender. For example, if a person needs to borrow $1,000, he or she might approach friends and family members to find someone with $1,000 to lend. This is not efficient when large amounts are involved.

INDIRECT FINANCING

In the case of indirect financing, a borrower does not deal directly with the person who has money to lend. Instead, he or she approaches a financial intermediary who acts as a middleman, bringing many borrowers and lenders together. The most common financial intermediaries are banks. Banks have a large pool of funds from their many depositors (lenders) that they can make available to borrowers. Other intermediaries include financial institutions such as investment banks, insurance companies, broker-dealers, investment funds and pension funds. Financial intermediaries offer a number of benefits to the average consumer including efficiency, diversity, and economies of scale. Dealers at these types of financial institutions have a range of products and financial instruments to offer prospective clients.

TYPES OF FINANCIAL INSTRUMENTs

There is a wide variety of investment products which investors can invest in. There are significant differences among investment products in terms of risk, volatility, return, income payments, and complexity. Many of the different types of Investments can play an important role in a well-diversified investment portfolio. However, whether your client should invest in a particular investment product depends on his or her personal circumstances, financial circumstances, investment needs and objectives, investment knowledge, risk profile, and time horizon.

FIXED INCOME

Fixed income instruments are issued by governments and corporations when they want to borrow money. These debt instruments include:

- money market instruments
- bonds
- debentures

Fixed income securities obligate the issuer to pay the investor interest over the term of the investment and the "par" or "face" value at maturity.

MONEY MARKET

Money market instruments are short-term debt instruments issued by governments and corporations that mature within one year. All money market instruments are issued at a discount and mature at par value. The difference between the discount value paid at purchase and the par value at maturity represents the instrument's return, taxed as interest income.

Money market instruments include:

- treasury bills
- bankers' acceptances
- commercial paper

Money market funds are investment funds which invest in money market instruments.

BONDS AND DEBENTURES

Bonds and debentures are debt instruments issued by governments and corporations with a term to maturity that exceeds one year.

BONDS

Corporate bonds are secured by specific assets that are pledged by the company. Government bonds are issued by the federal government or a province and the bonds are not secured by assets, but solely on the credit-worthiness of the government issuer.

DEBENTURES

Debentures are debt instruments issued by corporations that are not secured by specific assets. Municipal debentures are debt instruments issued by a municipal government.

EQUITIES

Equity securities, or simply equities, are shares issued by a corporation to the shareholders of the company. The shares represent ownership in the corporation, also known as share capital. The shareholders of a company own the residual interest in the company, after the prior claims of all creditors (including bond and debenture holders). The share capital of the corporation includes the common and preferred shares issued and outstanding.

COMMON SHARES

Common shares represent units of ownership in a company and returns are derived from the appreciation or depreciation in the share's value which is driven by the company's profitability. There are no contractual obligations for a company to pay dividends to common shareholders, although dividends are often paid on the common shares of highly profitable companies.

PREFERRED SHARES

Preferred shares are a class of share capital which carries contractual obligations for the company to pay the preferred shareholders a fixed dividend, ahead of common shareholders. Preferred shareholders also rank ahead of the common shareholders in the event of the company's insolvency and they have the right to receive par value for their preferred shares under such circumstances. However, preferred shareholders do not have the opportunity to profit from higher corporate earnings, as do common shares, since the dividend is fixed.

RIGHTS AND WARRANTS

Rights and warrants offer investors the right to purchase additional shares at a set price within a specified time period. Warrants are issued when the securities are originally brought to market and rights are issued subsequent to the original offer, to existing shareholders. Rights and warrants can be acquired by the existing shareholders, but they can also trade in the secondary market on an uncovered basis.

HYBRID SECURITIES

Hybrid securities are those which combine the attributes of two or more different financial instruments into a single security, for example a combination of capital and debt. These include traditional convertible debentures and contingent capital securities. Contingent capital securities are subordinated securities, such as subordinated debentures or preferred shares, which convert to common shares if a pre-specified trigger event occurs (e.g. financial conditions warrant re-capitalization, insolvency, etc.).

DERIVATIVES

Derivatives are contracts which give the holder the right to buy or sell an asset (e.g. financial instrument, commodity, etc.) and the value of the derivative is "derived" from the value of the underlying asset. Derivatives include options and futures contracts, and a pre-determined price and pre-determined time are established for the holder to exercise their right. Derivatives can trade on listed exchanges or on over-the-counter markets and trading strategies can be used to hedge against price changes or to speculate in the markets.

INVESTMENT FUNDS

An investment fund issues securities to investors in the same way as corporations that carry on an active business. However, unlike active businesses, they do not invest in plant and equipment or working capital. Instead, they invest in a portfolio of securities issued by other issuers. Investment funds can invest in all types of assets including money market instruments, bonds, preferred shares, and common shares.

Investment funds are managed by professional fund managers who buy and sell investments for the investment fund portfolio consistent with the objectives of each fund.

Investment funds can be either "open-ended" or "closed-ended". Under open-ended funds, as more investors purchase the fund, more units are issued. Under closed-ended funds, a fixed number of units are issued. Both open and closed investment funds invest in a portfolio of assets and units in the portfolio are issued to investors by way of prospectus.

Investment funds play an important role because they enable smaller investors to invest in a diversified manner in bond and stock markets. In the absence of investment funds, investing in the capital markets would not be economically practical or even possible for smaller investors.

MUTUAL FUNDS

Mutual funds are "open-ended" investment funds and they continuously issue and redeem units, so the number of units outstanding varies from day to day. If more units are redeemed than issued, the fund is said to have net redemptions. If more units are issued than redeemed, the fund is said to have net sales. Mutual funds are restricted from using leverage and limits are imposed in relation to the extent that they may use short selling or derivatives in their portfolio.

Mutual funds may be organized as trusts or as corporations. Trusts issue units and corporations issue shares. For the sake of convenience, we will use the term "units" whether the fund is a trust or a corporation.

Mutual funds have become increasingly popular. One reason for their popularity is because mutual funds have consistently outperformed traditional investments such as savings accounts, GICs, and term deposits, over the long term. With the decline of interest rates from the highs of the 1980s, investors have been looking for ways to earn a return that is higher than that of other savings vehicles. As people become more sophisticated in managing their money, and as their expectations increase about how investments should perform, they have turned to mutual funds to satisfy their investment needs. Investors have also become increasingly interested in long-term growth, specifically as it relates to retirement planning. As the general population's focus on RRSPs has grown, so too has the focus on mutual funds.

CLOSED-END FUNDS

Closed-end funds are diversified portfolios where a fixed number of shares of the portfolio are issued. Commonly, the shares of closed-end funds trade on a listed exchange in the same manner as listed common shares. Unlike mutual funds, closed-end funds have no limits on short selling.

EXCHANGE-TRADED FUNDS

Exchange-traded funds, or ETFs, are "open-ended" investment funds that trade on listed exchanges. ETFs invest in diversified portfolios, most commonly with the purpose of replicating a stock index or other financial benchmark or market sector. Unlike mutual funds, ETFs can use derivatives and alternative investment strategies to replicate the index that they follow. In the case of inverse, leveraged, and inverse leveraged ETFs, the fund seeks to generate returns opposite (inverse) of the index, returns which exceed the index by a multiple (e.g. 2X or 200%), or both. ETFs use derivatives, alternative investment strategies, and leverage in order to achieve the desired inverse/leveraged results. Similar to mutual funds, ETFs have become increasingly popular since ETFs, in tandem with the indices they follow, have outperformed the traditional savings vehicles over the longer term.

OTHER INVESTMENTS

There is a wide variety of investment products available in the financial marketplace. As innovators in the marketplace continue to develop new products tailored to the needs of investors and issuers of capital, new and innovative investment products are continually brought to market. Some of these investment products include structured products which have been introduced more recently including principal protected notes (PPNs). Other traditional investments include cash equivalents such as guaranteed investment certificates (GICs). The universe of available investment products is vast and evolving. While many of these investment products may be attractive in a well-diversified portfolio, you will need to conduct ample due diligence on any investment product that you consider for your clients.

The Public Capital Markets 2

CONTENT AREAS

INTRODUCTION

This lesson introduces the public capital markets and how they operate in Canada. You will learn how a security is initially brought to market and then traded in the secondary market.

This lesson takes approximately 30 minutes to complete.

LEARNING OBJECTIVES

At the end of this lesson, you will be able to:

1 | Explain the prospectus requirement.

2 | Discuss the continuous disclosure regime for reporting issuers.

3 | Describe the initial public offering process and how securities are brought to market.

4 | Compare the types of underwriting methods.

5 | Describe the secondary market, including stock exchanges, over-the-counter (OTC) markets and Alternative Trading Systems (ATS).

6 | Describe the roles of the participants in the public markets.

PRIMARY AND SECONDARY MARKETS

Securities and financial instruments are brought to market and traded in the capital market. The capital market brings together corporations, entrepreneurs, governments, and other organizations seeking capital, with investors and lenders that supply capital. Entities seek to raise capital for various reasons including the need for expansion, research and development, or an increase in working capital for the purpose of repaying debt.

The capital market is divided into two markets:

- the primary market
- the secondary market

The **primary market** is where securities (like stocks and bonds) are issued or sold to investors for the first time by an issuer, through a public or private offering of securities.

After securities are initially sold by an issuer to investors, the securities can then be traded in the **secondary market**.

HOW SECURITIES ARE BROUGHT TO MARKET

How securities are issued for the first time in the primary market depends on whether they are sold under a prospectus or under an exemption from the prospectus requirement.

The primary market is divided into two markets:

- public markets
- private markets

The **public market** is where the securities of publicly listed companies are offered by prospectus.

The **private market** is where the securities of private (exempt) issuers are offered under an exemption from prospectus requirements.

Under Canadian securities legislation, if securities are not sold under a prospectus or a prospectus exemption, it is an illegal distribution.

THE PUBLIC OFFERING PROCESS

When an issuer sells securities in the public market for the first time, it is known as an initial public offering (**IPO**).

THE PROSPECTUS REQUIREMENT

A number of regulatory requirements must be observed before an initial issue of securities may be sold in the public market. The process begins with the filing of a preliminary prospectus.

Under securities legislation in Canada, issuers must file a prospectus in order to offer their securities for sale in the public market. The prospectus is an offering document which must be filed with the securities regulator in each province/territory where the securities will be sold.

A company that distributes securities under a prospectus is called a **reporting issuer**. Reporting issuers are subject to certain continuous reporting obligations which require that they provide reports to the securities regulators and to existing investors. For example, a reporting issuer must provide reports including:

- unaudited quarterly financial reports
- audited annual financial statements
- management's discussion and analysis
- information circulars in connection with meetings of security holders

Reporting issuers must also provide the regulators and existing investors with prompt announcements in connection with any material changes that occur in their business, operations, or capital.

THE PRELIMINARY PROSPECTUS

The **preliminary** prospectus must carry a bold disclosure in red ink on the cover page which indicates that information in the prospectus is not complete and the securities may not be sold until regulatory approval (i.e. regulatory receipt) has been obtained.

Issuers must use the form of prospectus prescribed by the securities regulators. The majority of issuers must use the "long form" prospectus, particularly in the case of IPOs, while different forms of prospectus exist for investment funds, issuers that qualify for short form prospectus, etc.

The electronic filing system in Canada for the disclosure documents of public companies and investment funds is the System for Electronic Document Analysis and Retrieval (**SEDAR**). The preliminary prospectus, final prospectus and any material agreements which are summarized in the prospectus (e.g. agency or underwriting agreement) are to be filed on SEDAR. SEDAR is available to the investing public at www.sedar.com.

The offering issuer is also required to file press releases announcing the offering and the closing of the offering, and to file certain other documents required by the securities regulators (e.g. documents affecting shareholders' rights, reports and consents of experts, etc.).

REGULATORY RECEIPT

When a preliminary prospectus or a final prospectus is filed with the Canadian securities regulators, it is reviewed for conformity with securities legislation. Following their review, the securities commissions may make comments to the offering issuer and the issuer must respond to these comments. When satisfactory responses have been provided to their comments, the securities commissions issue a receipt.

Note: A receipt for a preliminary prospectus or a final prospectus does not constitute an endorsement that the securities offered pursuant to it are a good investment. It only means the prospectus has been reviewed for conformity with securities legislation.

PASSPORT SYSTEM

In Canada, preliminary and final prospectuses are reviewed under the Passport System. The Passport System streamlines the prospectus filing and registration processes in Canada, the continuous disclosure requirements for public issuers, and applications for prospectus exemptions by private (exempt) issuers.

The securities commissions in all jurisdictions have joined the Passport System except Ontario. Under the passport system, the offering issuer deals with only one securities commission, called the principal regulator. In most cases, the principal regulator is the securities commission in the province or territory where the head office of the offering issuer is located.

The offering issuer must still file the prospectus in every applicable jurisdiction via SEDAR and pay the filing fees in every jurisdiction. What happens next differs depending upon whether the principal regulator is the Ontario Securities Commission (**OSC**) or not:

- If the principal regulator is the OSC, it will review the prospectus and, if satisfied, issue a receipt which will also trigger a deemed receipt in the other applicable jurisdictions.
- If the principal regulator is not the OSC, the principal regulator will review the prospectus and the OSC will conduct its own review in tandem with the principal regulator using a passport interface mechanism. This is known as a dual review. If the OSC has concerns that it is not able to resolve, it may opt out of the dual review.
- If the OSC opts out of a review, the offering issuer will need to deal directly with the OSC to address its concerns.
- If the OSC does not opt out, a receipt issued by the principal regulator will also evidence that the OSC has issued a receipt.

In either case, a receipt issued by the principal regulator will trigger a deemed receipt in each other passport jurisdiction where the prospectus has been filed. Under this system, offering issuers do not need to negotiate with thirteen securities commissions in Canada. In most cases, they will need to deal only with the principal regulator.

ENTERING INTO AGENCY OR UNDERWRITING AGREEMENTS

As part of a public offering, the offering issuer initially enters into an engagement letter with a lead investment dealer that sets out the terms and conditions of the offering including the size, structure, sometimes the price of the security, the selling commission, expense reimbursement, basic termination provisions, an indemnity in favor of the investment dealer, and other matters. When the preliminary prospectus is filed, the issuer and underwriters enter into an agency (or underwriting) agreement which supersedes the engagement letter. The agency or underwriting agreement is encompassed in summary form into the prospectus.

ROLE OF UNDERWRITERS IN A PUBLIC OFFERING

Investment dealers play an important role as underwriters in connection with securities offered by prospectus in the primary market. Underwriting generally means the process of selling securities for offering issuers. In a prospectus offering, a group of investment dealers (or underwriters) combine their efforts to sell securities through what is called an **underwriting syndicate**. Working as a group, the underwriters share any risks that may be associated with a particular offering and split the selling commissions. Usually, one investment dealer acts as the lead underwriter of the syndicate.

Underwriters are crucial to the primary public market. Their role includes three key activities:

- advising on the timing and manner of distribution of the securities
- completing due diligence, assisting in the creation of the prospectus, and advising and setting the price for the new securities
- selling the new securities to investors

TYPES OF UNDERWRITINGS

Generally, there are three types of underwritings:

- a "best efforts" underwriting
- a "bought deal" underwriting
- a "marketed offering" underwriting

BEST EFFORTS UNDERWRITING

Under a best efforts underwriting, the underwriters agree to use their best efforts to ensure that as much of the offering is sold at the specified price. The underwriters do not guarantee to sell a specified amount of the issue and they do not assume risks for any unsold part of the issue. Generally, no advertising or marketing activities that can be viewed as promoting are permitted prior to the filing of the preliminary prospectus.

BOUGHT DEAL UNDERWRITING

Under a bought deal underwriting, the underwriters in the syndicate guarantee a specified amount of capital to the reporting issuer. The underwriters agree to purchase a specified number of securities, at a specified price, at a specified time. In essence the underwriters act as principals since they buy the securities from the issuer and then resell them into the market. However, if the underwriters are unable to sell all the allotted securities, the underwriters are still obligated to purchase the securities at the agreed upon price.

A bought deal involves significant risks for the underwriters since there is no guarantee that the underwriting syndicate will be able to sell all the allotted securities purchased in the offering. It should be noted that exempt market dealers also engage in bought deals in the private markets.

MARKETED OFFERING UNDERWRITING

Under a marketed offering underwriting, the underwriters act as principals and they buy the securities from the reporting issuer and then resell them into the market. However, unlike a bought deal, the underwriting agreement is not signed until after the preliminary prospectus is filed. Therefore, the number of securities and offering price of the security is not set out in the preliminary prospectus. Once the preliminary prospectus is filed and receipted, the underwriters begin marketing activities in order to assess the market for the securities. After assessing the market for the securities, the number and price of the securities is set.

SOLICITING INTEREST FOR AN IPO

As advisors to the offering issuer, underwriters want to ensure that a new issue passes through the market successfully. After a preliminary prospectus has been receipted, but before any new securities come to market, investment dealers contact their clients seeking 'expressions of interest' to get an idea of whether there is a demand or interest for a particular security.

Underwriters are able to use the preliminary prospectus as a marketing tool to assess the demand for the new issue in the marketplace. They are required to document the names of everyone who receives the preliminary prospectus, so that if amendments are made, the potential investors can be notified and receive an amended prospectus, including the final prospectus.

The underwriters are limited in what they can do to sell the securities while the preliminary prospectus is being reviewed by the securities commissions. This is called the **waiting period**.

ADVERTISING AND MARKETING

The advertising and marketing that is conducted for new public offerings include:

- the green sheet
- the standard term sheet
- marketing materials
- road shows

Advertising and Marketing – New Public Offerings	
Green Sheet	A green sheet is a simplified summary of the prospectus which is typically provided to registered representatives to assist them in understanding the issuer, the securities, and the offering.
Standard Term Sheet	A term sheet provides potential investors with the contact information for the underwriters, a brief description about the issuer and the securities offered, and a legend with cautionary language.
Marketing Materials	An underwriter can provide certain other marketing materials to a potential investor during the waiting period, subject to strict conditions and disclosure requirements. Marketing materials include any written communication that contains material facts other than the prospectus, a prospectus amendment/notice, or the standard term sheet.
Road Shows	A road show is a presentation to potential investors regarding a distribution of securities under a prospectus.

SETTING THE SHARE PRICE AND OTHER SECURITY FEATURES

Underwriters advise issuers on the price of the security being offered, the rate of interest and term to maturity (in the case of fixed income), and the dividend rate (in the case of a preferred shares). Other recommendations may include call features or convertible features.

THE FINAL PROSPECTUS

The preliminary prospectus is reviewed by the securities regulators and, where required, amendments are made to the prospectus. Where a minimum offering is established, and satisfied, the final prospectus and the agency agreement (with the underwriting syndicate) is filed. If there are any material changes made to a preliminary prospectus, the issuer will be required to file an amended preliminary prospectus and provide it to investors.

Figure 1.1

INVESTOR RIGHTS

Securities legislation in Canada imposes a rigorous standard of responsibility and liability in connection with a prospectus offering. Where a prospectus contains a "misrepresentation", each investor is deemed to have relied on the misrepresentation and has a right of action for damages against the offering issuer and possibly against each underwriter, director, officer, promoter or expert who signs the prospectus.

Under secondary market civil liability, if an issuer releases a document that contains a misrepresentation, an investor who acquires or sells the issuer's security between the time when the document was released and the time when the misrepresentation was publicly corrected has a right of action for damages against the issuer and certain other parties. The misrepresentation may be in any document, including a continuous disclosure document.

Secondary market civil liability also applies where an issuer fails to make a timely disclosure of a material change. Where timely disclosure has not been made, an investor who acquires or sells the issuer's security between the time when the material change was required to be disclosed and the time when it was subsequently disclosed has a right of action for damages against the issuer and certain other parties.

THE SECONDARY MARKET

After securities are initially sold to investors in the primary market, they are then traded in the secondary market by individual and institutional investors.

There are three main types of secondary markets:

- Stock Exchanges
- Over-the-counter (OTC) markets
- Alternative Trading Systems

Most equity trades take place on an exchange. However, the majority of bond trades take place on the OTC market.

STOCK EXCHANGES

Stock exchanges are the most publicly recognized places for buying and selling shares in the secondary market. The common and preferred shares of publicly listed companies are traded on the stock exchanges. Companies must apply to be listed on an exchange. If accepted, the company must comply with the exchange's listing requirements including the rules concerning the disclosure of information for reporting issuers. Some of the benefits of listing on an exchange include:

- increased marketability of shares due to greater market exposure
- increased public confidence in the company
- an active secondary market that can broaden a company's shareholder base

The investment dealers who trade listed securities on the stock exchanges must become members of the exchange and must comply with the Universal Market Integrity Rules (UMIR) governing trading in the public secondary markets in Canada.

OVER-THE-COUNTER MARKET

Over-the-counter (**OTC**) markets have no central location. Instead, individual dealers create liquidity in the market by negotiating amongst themselves. No intermediary or facility is used to match the buy and sell orders.

OTC markets are less transparent than exchanges. In the case of an exchange, all bids and offers are entered into the exchange's order book and are visible to market participants. This is known as pre-trade transparency. In the case of an OTC market, there is no central order book and the only way to obtain quotes is to contact each dealer individually. Bonds are typically traded in the OTC market.

ALTERNATIVE TRADING SYSTEMS

An Alternative Trading System (ATS) is an automated secondary trading marketplace. Like an exchange, an ATS matches buy and sell orders. However, unlike an exchange, an ATS does not:

- require issuers to become listed on the ATS
- guarantee a two-sided market for a security on a continuous basis
- govern the conduct of its subscribers other than in connection with trading on the ATS
- discipline its subscribers other than to exclude a subscriber from participation in the ATS in appropriate circumstances

ROLES IN THE PUBLIC MARKET

THE PARTICIPANTS THAT MAKE UP THE PUBLIC MARKET ARE SUMMARIZED IN THE TABLE BELOW.

Public Market Participants	
Issuers	Governments and corporations who raise capital in the public market by offering securities by prospectus
Investment Dealers	Registered firms who: • act as underwriters in the primary market • sell prospectus securities to investors in the secondary market • trade prospectus securities with each other as principals in the over-the-counter (OTC) market
Mutual Fund Dealers	Registered firms that sell prospectus investment funds to investors
Dealing Representatives	Individual registrants who recommend and sell prospectus securities to investors on behalf of their investment dealers and mutual fund dealers
Stock Exchanges and Alternative Trading Systems (ATS)	Intermediaries that facilitate trades of publicly listed securities in the secondary market
Securities Commissions/ Regulators	The securities commissions (or equivalent) in each of the provinces/territories who have oversight over the issuers, investment dealers, mutual fund dealers, Dealing Representatives, stock exchanges, and ATSs

Private or Exempt Capital Market

3

CONTENT AREAS

INTRODUCTION

In this lesson you will learn about the Exempt Market (also called the Private Capital Market). This lesson covers the main characteristics of the exempt market, and what exempt dealers do.

The lesson takes approximately 25 minutes to complete.

LEARNING OBJECTIVES

At the end of this lesson, you will be able to:

1 | Define the exempt market.

2 | Explain and summarize the common prospectus exemptions.

3 | Describe the roles of the participants in the exempt market.

4 | Discuss the availability of information on non-reporting issuers.

5 | Explain what exempt market dealers do.

6 | Identify the different types of investors in the exempt market.

7 | Describe the unique features of distributing exempt securities including the risks of exempt securities.

WHAT IS THE EXEMPT MARKET?

To understand the exempt market, you need to understand two fundamental concepts under securities law:

- the prospectus requirement
- the registration requirement

Both requirements are intended to protect the investing public.

The **prospectus requirement** requires an issuer to file a prospectus in order to distribute securities to the public. This is meant to ensure that investors are provided with relevant information about an issuer and its offering to help them make an informed investment decision. Securities offered by way of prospectus provide the investor with certain statutory rights in the event of a misrepresentation in a prospectus including the right to sue for damages.

The **registration requirement** requires that parties involved in the business of trading or advising in securities become registered with the securities regulators. This is meant to ensure that individuals and firms who deal in securities are suitable and meet the requirements for proficiency, integrity, and solvency. The registration requirement also requires, among other things, that registrants comply with certain "Know Your Product", "Know Your Client", and suitability requirements.

An exempt security is a security that is distributed under an exemption from the prospectus requirement or the dealer registration requirement. Securities that are offered for sale under an exemption from prospectus requirements are often called **private placements**. The market in which exempt securities are traded is known as the **exempt market** or **private market**.

Originally, each jurisdiction of Canada had its own set of exemptions from the prospectus and registration requirements. The exemptions were largely harmonized when National Instrument 45-106 *Prospectus and Registration Exemptions* (NI 45-106) became effective in all jurisdictions of Canada. Nevertheless, some jurisdictions have maintained local exemptions and, in certain cases, some jurisdictions have opted out of some of the exemptions in the instrument.

RATIONALE FOR PROSPECTUS EXEMPTIONS

Issuers must weigh the many considerations including costs, continuous disclosure requirements, timing, and corporate governance when deciding whether it is more beneficial to distribute their securities by way of a public distribution or a private placement. It is likely that the lower costs and reduced regulatory requirements associated with a private placement allow many issuers, who would not otherwise be willing or able, to access the capital markets. As such, private placements broaden the capital markets and play a vital role in the Canadian economy by facilitating access to capital. In certain circumstances, it may be more effective for small and medium sized issuers to raise capital in the exempt market.

PROSPECTUS EXEMPTIONS AT A GLANCE

Where an issuer decides to distribute their securities in the exempt market, they do so under an exemption from the prospectus requirement. Some of the commonly used prospectus exemptions are summarized in the table below.

Prospectus Exemptions		
Exemption	**Rationale/Premise for Exemption**	**Details**
Accredited investor (AI) exemption	Sophisticated investors who do not require the protection of prospectus-type disclosure including: • institutions • registered advisers and dealers • governments • investment funds • fully managed accounts • high net worth individuals: ◦ the issuer must obtain a signed risk acknowledgement in prescribed form (Form 45-106F9) from the purchaser before or at the time of the transaction	Individual accredited investor: • an individual who, alone or with a spouse, beneficially owns, directly or indirectly, net financial assets with a realizable value exceeding $1 million or has net assets of at least $5 million • an individual whose net income before taxes exceeded $200,000 (or $300,000 when including the spouse's income) in each of the two most recent calendar years and who expects to exceed that net income level in the current calendar year

<table>
<tr><th colspan="3">Prospectus Exemptions</th></tr>
<tr><th>Exemption</th><th>Rationale/Premise for Exemption</th><th>Details</th></tr>
<tr><td>Offering memorandum (OM) exemption</td><td>The investor receives disclosure from the issuer.

The issuer:
delivers an Offering Memorandum in prescribed form to the purchaser, and
obtains a signed risk acknowledgement in prescribed form (Form 45-106F4/F5) from the purchaser.
Note: In some jurisdictions, a ceiling of $10,000 on the acquisition cost applies unless the purchaser qualifies as an eligible investor.</td><td>Eligible investor under the offering memorandum (OM) exemption:

An individual whose:
net assets, alone or with a spouse, in the case of an individual, exceed $400,000
net income before taxes exceeded $75,000 in each of the two most recent calendar years and who reasonably expects to exceed that income level in the current calendar year, or
net income before taxes, alone or with a spouse, in the case of an individual, exceeded $125,000 in each of the two most recent calendar years and who reasonably expects to exceed that income level in the current calendar year</td></tr>
<tr><td>Family, friends, and close business associates (FFBA) exemption</td><td>The securities are issued to an investor who has a relationship with the issuer and therefore does not require the protection of prospectus-type disclosure
onus is on the issuer to establish whether a close personal relationship exists
the issuer must obtain a signed risk acknowledgement in prescribed form from the purchaser (Form 45-106F12)</td><td>The investor has a relationship with the issuer including:
directors, executive officers, control persons, and founders of the issuer
family members, close personal friends, and close business associates of directors, executive officers, control persons, or founders of the issuer:
spouse
parent
grandparent
brother
sister
child
grandchild
close personal friend
close business associate</td></tr>
</table>

Prospectus Exemptions		
Exemption	**Rationale/Premise for Exemption**	**Details**
Minimum amount (MA) exemption (or the $150,000 exemption)	Investors who are not individuals, invest large amounts, are sophisticated, and do not require the protection of prospectus-type disclosure	The investor: • is not an individual • buys the securities as principal • the securities have an acquisition cost to the purchaser of not less than $150,000 • the purchaser pays the acquisition cost at the time of the trade • the trade is in respect of a security of a single issuer
Private issuer exemption	The securities are issued by a private issuer to an investor who has a relationship with the private issuer and therefore does not require the protection of prospectus-type disclosure	Private issuer: An issuer that limits the number of security holders (outside of employees/ former employees) to 50. The investor has a relationship with the private issuer including: • director • officer • employee • founder • control person • close family member
Specified debt exemption (more commonly known as the *government debt exemption* or *bank debt exemption*) **Short-term debt exemption**	Fixed income securities that are safe and have high credit ratings assigned by the designated ratings organizations (DROs)	Fixed income securities of governments (federal and provincial), banks, and short-term corporate paper that is: • not securitized • not convertible, exchangeable, or accompanied by a right to purchase another security

Prospectus Exemptions		
Exemption	**Rationale/Premise for Exemption**	**Details**
Short-term securitized product exemption	Fixed income securities that are safe, have high credit ratings assigned by the designated ratings organizations (DROs), and principal and interest obligations are guaranteed	Fixed income securities that: • have high credit ratings assigned by at least 2 designated ratings organizations (DROs) • do not have any credit ratings below a certain level assigned by any DRO • principal and interest obligations are guaranteed by an approved "liquidity provider" • the securitized product is offered under an *Information Memorandum* in the prescribed form (Form 45-106F7) • the issuer provides *Monthly Disclosure Reports* in the prescribed form (Form 45-106F8) • the issuer satisfies certain disclosure requirements for material changes, changes in credit ratings, defaults, etc.

SECONDARY MARKET

There are secondary markets for publicly listed companies such as stock exchanges. On the contrary, there is no secondary market for private (or exempt) securities. Securities of private issuers are generally considered illiquid investments since they cannot be easily resold. Where private (or exempt) securities are bought and sold by institutional investors, for example between a pension, private equity fund or hedge fund, the transactions are privately arranged. In the case of retail investors, the securities may not be liquidated unless the issuer has a liquidation facility and in most cases such facilities are remote. Where exempt issuers offer a redemption feature, the redemptions are often subject to lock-up periods, advance notice, and the suspension of redemptions all together. Therefore, in many cases, the investor cannot liquidate the security and must hold the security as established in the initial offering.

ROLES IN THE EXEMPT MARKET

THE PARTICIPANTS THAT MAKE UP THE PRIVATE (EXEMPT) MARKET ARE SUMMARIZED IN THE TABLE BELOW.

Private (Exempt) Market Participants	
Issuers	Corporations who raise capital in the private (exempt) market by offering exempt securities
Exempt Market Dealers and Investment Dealers	Registered firms who sell exempt securities to investors

Private (Exempt) Market Participants	
Dealing Representatives	Individual registrants who recommend and sell exempt securities to investors on behalf of their exempt market dealers or investment dealers
Securities Commissions/Regulators	The securities commissions (or equivalent) in each of the provinces/territories who have oversight over the issuers, exempt market dealers, and Dealing Representatives
Investors	Individuals and institutions who purchase exempt securities

TYPES OF INVESTORS IN THE EXEMPT MARKET

In the exempt market, securities are restricted from being offered to the general public. Exempt securities may only be offered to investors who meet certain requirements prescribed under prospectus exemption. Investors in the exempt market include:

- **Accredited investors** including:
  - institutions, governments, and investment funds
  - high-net-worth individuals
- **Eligible investors** who are permitted to purchase the exempt securities under the offering memorandum exemption
- **Angel investors** are individual accredited investors that get involved in early stage financings who take an active involvement in the business, for example, as an advisor or member of the board of directors. Angel investors typically invest before venture capital investors.
- **Venture capital (VC) investors** are typically organized as a venture capital fund, they seek high returns in start-up and early stage issuers, and often seek to be involved in the management and control of the issuer.
- **Private equity investors** are typically high net worth individuals and institutional investors that have pooled their money into a private equity fund for the purposes of investing and acquiring control of private companies. Private equity investors seek high risk returns over a short investment time horizon and usually make large investments.
- **Institutional investors** are banks, trust companies, pension funds, governments (federal, provincial and municipal), investment funds (including hedge funds), and private equity investors.
- **Permitted clients** are generally foreign and domestic institutional investors and certain types of individuals and companies that have assets in excess of certain amounts.

EXEMPT MARKET DEALERS

Exempt market dealers may carry out the activities established in Part 7.1(d) of National Instrument 31-103 - Registration Requirements, Exemptions and Ongoing Registration Obligations (NI 31-103). Simply stated, exempt market dealers facilitate trades in exempt securities between issuers and investors for a commission.

Generally, an exempt market dealer can:

- act as a dealer by trading in a security that is distributed under a prospectus exemption
- act as an underwriter in respect of a distribution of securities that is made under a prospectus exemption

Investment dealers are also permitted to offer exempt securities to investors.

DISTRIBUTING EXEMPT SECURITIES

There are unique features to the securities that are offered in the exempt market and unique requirements that apply in the distribution process such as:

- Reporting prospectus-exempt distributions
- Risk acknowledgement
- Issuer information
- Investor rights
- Resale restrictions

REPORTING PROSPECTUS-EXEMPT DISTRIBUTIONS

Under the accredited investor exemption and the offering memorandum exemption, reports must be filed with the securities regulators such as a “report of exempt distribution” or a “report of trade”. A report of trade must be filed within 10 days of the trade and requires the payment of applicable filing fees.

RISKS OF EXEMPT SECURITIES AND RISK ACKNOWLEDGEMENT

For exempt securities offered to investors under the accredited investor (AI), offering memorandum (OM), and family, friends and close business associates (FFBA) exemptions, the issuer is required to obtain a signed risk acknowledgement in prescribed form from the purchaser.

The *Risk Acknowledgement Form* contains a summary, by the securities commissions, of exempt securities and the risks of investing in them.

In particular, the form asks the investor to acknowledge that:

- the exempt security is a risky investment
- the investor could lose all the money they invest
- the investor may not be able to sell the investment quickly – or at all
- the investor could receive little or no information about their investment
- the investor is investing entirely at their own risk
- no securities regulatory authority has evaluated or endorsed the merits of the security or the disclosure in the offering memorandum
- the security is not listed on any stock exchange, they may never be listed, and the investor may never be able to sell the securities
- the issuer of the security is not a reporting issuer, does not have to publish financial information or notify the public of changes in its business, and the investor may not receive ongoing information about this issuer

LIMITED AVAILABILITY OF INFORMATION ABOUT EXEMPT ISSUERS

A prospectus must be filed with the securities commissions prior to a public distribution of securities. The contents of a prospectus are prescribed by securities legislation and are designed to provide the investor with all the information necessary to make an informed decision on whether to buy the security. The prospectus is reviewed by the securities commissions to ensure it complies with the requirements of securities legislation.

Issuers that offer securities for sale under a prospectus exemption do not generally prepare a disclosure document as comprehensive and detailed as a prospectus. While the contents of offering memorandums are prescribed in

NI 45-106, they only apply to exempt securities offered under the offering memorandum exemption and unlike prospectuses, offering memorandums are not reviewed by the securities commissions.

Offering memorandums are also used by issuers for securities offered under exemptions other than the offering memorandum exemption, for example the accredited investor exemption. However, the offering memorandums under those exemptions are not required to comply with the requirements established in NI 45-106 for the offering memorandum exemption. The issuer is free to disclose as much or as little information as it wishes. To avoid confusion, the disclosures are sometimes referred to by a different name, such as *information circular*, but this is not always the case. Therefore, in most cases, the onus is on the investor to decide whether the disclosure document contains sufficient information to make an informed decision.

Issuers that offer exempt securities are also not subject to the continuous reporting requirements for public issuers. Therefore, exempt securities are not transparent and investors may not be aware of the financial circumstances of the issuer. Unlike reporting issuers of publicly listed securities, there is no public repository for investors to obtain financial information on exempt issuers.

INVESTOR RIGHTS

Investors in exempt securities are not afforded the same legal rights that are available to investors who purchase prospectus-based investments. The right of action for damages for a "misrepresentation" are limited in comparison to prospectus-based securities. This means that there are limitations on the rights to claim damages or any other remedies from the issuer or underwriter for misstatements or misrepresentations in the offering documents, marketing documents, or any subsequent documents released or for failing to make timely disclosure of material changes.

RESALE RESTRICTIONS

Securities distributed pursuant to an exemption from the prospectus requirement are subject to resale restrictions, with the exception of those securities distributed under the government debt exemption, bank debt exemption, and short-term debt exemption. Those securities may be freely traded.

The vast majority of exempt securities distributed by EMDs and Dealing Representatives are subject to resale restrictions. The system is "**closed"** and you cannot trade outside of a prospectus exemption unless:

- the prospectus requirement is satisfied (i.e. the issuer becomes a reporting issuer)
- certain resale restrictions are met

The securities of issuers which are not reporting issuers may be subject to indefinite resale restrictions. This restricts securities issued under a prospectus exemption from entering the secondary market.

COMPARISON: PUBLIC AND PRIVATE MARKET

How securities are offered in the capital market depends on whether they are sold under a prospectus or under an exemption from the prospectus requirement.

The **public market** is where the securities of publicly listed companies are offered by prospectus.

The **private market** is where the securities of private (exempt) issuers are offered under an exemption from prospectus requirements.

There are unique features to the securities that are offered in the public and private (exempt) markets and unique requirements that apply in the distribution processes. A comparison of the public and private markets is summarized in the table below.

Public and Private Market	
Public Market	**Private (Exempt) Market**
Primary market: • Initial Public Offering (IPO) offered by prospectus ◦ Preliminary prospectus ◦ Final prospectus ◦ Prospectuses filed and reviewed by the securities commissions/regulators	**Primary market:** • Securities offered under an exemption from prospectus requirements ◦ Offering documents (e.g. offering memorandums) are not filed or reviewed by the securities commissions/regulators
Reporting Issuer: • Continuous disclosure ◦ Financial statements, management discussion, information circulars ◦ Public announcements of material changes	**Exempt Market Issuer:** • No continuous disclosure obligations
Dealers: • Investments Dealers • Mutual Fund Dealers	**Dealers:** • Exempt Market Dealer • Investment Dealers
Investors: • No restrictions on who can invest (provided that they are of legal age, capacity)	**Investors:** • Offering is restricted to certain types of investors (e.g. accredited investors, eligible investors, etc.).
Investor Rights: • Right of action for damages for a "misrepresentation": ◦ Right of rescission ◦ Right of withdrawal ◦ Secondary market civil liability	**Investor Rights:** • Investors in exempt securities are not afforded the same legal rights that are available to investors who purchase prospectus-based investments • The right of action for damages for a "misrepresentation" are limited in comparison to prospectus-based securities
Secondary Market: • After IPO, securities trade in the secondary market: ◦ Stock exchanges ◦ Alternative Trading Systems (ATS) ◦ Over-the-Counter (OTC)	**Secondary Market:** • No secondary market for exempt securities ◦ Institutions (e.g. pensions, private equity funds, hedge funds) privately arrange any transaction ◦ Retail investors cannot re-sell exempt securities and there is no secondary market
Reporting: • No reports filed on distributions/trades of publicly listed securities	**Reporting:** • Must be filed with the securities regulators: ◦ Prospectus-exempt distribution ◦ Prospectus-exempt trade

Public and Private Market	
Public Market	**Private (Exempt) Market**
Risk Acknowledgement: • No risk acknowledgement	**Risk Acknowledgement:** • Required under the accredited investor (AI), offering memorandum (OM), and family, friends, and close business associates (FFBA) exemptions • The issuer must obtain a signed risk acknowledgement in prescribed form from the purchaser before or at the time the exempt security is purchased
Resale Restrictions: • No resale restrictions • Freely traded in the secondary market	**Resale Restrictions:** • Can only be resold using a further prospectus exemption • Cannot trade outside of a prospectus exemption

UNIT SUMMARY

Congratulations, you have reached the end of Unit 1: Overview of the Capital Markets.

In this unit you covered:

- Lesson 1: Investment Capital
- Lesson 2: The Public Capital Markets
- Lesson 3: Private or Exempt Capital Market

Now that you have completed these lessons, you are ready to assess your knowledge with a 10-question quiz. To start the quiz, return to the IFSE Landing Page and click on the Unit 1 **Quiz** button.

UNIT 2

REGULATORY FRAMEWORK

INTRODUCTION

Securities regulations in Canada establish uniform requirements and registration categories for dealers in the exempt market. This unit introduces the main regulatory bodies that govern the exempt market and covers registration requirements.

This unit takes approximately 1 hour to complete.

Lessons in this unit:

1. Regulatory Environment
2. Registration Requirements

Regulatory Environment 1

CONTENT AREAS

- Securities Commissions/Regulators
- Canadian Securities Administrators
- Client Relationship Model and Client Focused Reforms
- Self-Regulatory Organizations
- Investment Industry Regulatory Organization of Canada
- Mutual Fund Dealers Association of Canada
- Chambre de la sécurité financière
- Bourse de Montréal
- Exempt Market Dealers Regulation
- Authority of the Securities Regulators and SROs

INTRODUCTION

Exempt market dealers and Dealing Representatives are accountable to the authorities who have oversight of the capital markets. It is important that you are aware of the regulations that must be followed and to understand the spirit of those regulations. This lesson covers the regulatory bodies in the Canadian securities industry.

This lesson takes approximately 30 minutes to complete.

LEARNING OBJECTIVES

At the end of this lesson, you will be able to:

1 | Understand the role of the provincial securities commissions/regulators.

2 | Describe the Canadian Securities Administrators and explain some of the efforts to harmonize and enhance regulation in the Canadian securities industry.

3 | Discuss requirements under the Client Relationship Model (CRM) and Client Focused Reforms (CFR).

4 | Describe the self-regulatory organizations (SROs) in Canada.

5 | Discuss the regulation of exempt market dealers.

SECURITIES COMMISSIONS/REGULATORS

The securities industry is governed by the securities legislation of the provinces and territories of Canada. The responsibility for administering and enforcing the securities legislation in each jurisdiction rests with the securities commission or equivalent authority in each of the provinces and territories.

Securities commissions have a mandate to:

- protect investors from unfair, improper, and fraudulent practices
- promote fair and efficient capital markets
- reduce systemic risk

Each province and territory has a securities commission/regulator. In some jurisdictions, the securities regulator is dedicated solely to securities regulation. For instance, in Ontario, the Ontario Securities Commission (OSC) is the securities regulator. Separately, the Financial Services Commission of Ontario (FSCO) regulates insurance distribution, provincial trust and loan companies, and provincial pension funds.

In other jurisdictions, the regulation of financial services is integrated to some extent. In Québec, the Autorité des marchés financiers (AMF) regulates securities, insurance distribution, and provincial trust and loan companies while Retraite Québec regulates provincial pension funds. Saskatchewan has the most integrated financial services regulator. The Financial and Consumer Affairs Authority of Saskatchewan regulates all aspects of financial services in the province including securities, insurance distribution, provincial trust and loan companies, and provincial pension funds.

For registered firms that are directly regulated by the provincial and territorial securities regulators, the rules, regulations, and legislation apply specifically to securities, and are not extended to related investment products. Firms that are directly regulated by the provincial and territorial securities regulators include exempt market dealers (EMDs), investment fund managers (IFMs), portfolio managers (PMs), and scholarship plan dealers (SPDs).

This differs from the regulatory requirements for registered firms who are regulated by the self-regulatory organizations (SROs). SRO-regulated firms include investment dealers, who are members of the Investment

Industry Regulatory Organization of Canada (IIROC), and mutual fund dealers, who are members of the Mutual Fund Dealers Association of Canada (MFDA). SRO member firms are subject to rules and regulations that apply to securities and related investment products, including structured products. Notwithstanding this differentiation, the terms “securities” and “investment products” are used interchangeably for the purposes of this course.

CANADIAN SECURITIES ADMINISTRATORS

The securities regulators in Canada are members of the Canadian Securities Administrators (CSA), an umbrella body whose mandate is to improve, coordinate, and harmonize securities regulation across Canada. The CSA has a permanent secretariat which is located in Montreal.

The members of the CSA are the:

- Alberta Securities Commission
- British Columbia Securities Commission
- Manitoba Securities Commission
- New Brunswick Financial and Consumer Services Commission
- Office of the Superintendent of Securities Service, Newfoundland and Labrador
- Office of the Superintendent of Securities, Northwest Territories
- Nova Scotia Securities Commission
- Nunavut Securities Office
- Ontario Securities Commission
- Office of the Superintendent of Securities, Prince Edward Island
- Autorité des marchés financiers, Québec
- Financial and Consumer Affairs Authority of Saskatchewan
- Office of the Yukon Superintendent of Securities

CSA PROGRAMS

As part of their mandate, the CSA manages several programs, systems, and instruments including the:

- Passport System
- Electronic Databases
- National Instruments

PASSPORT SYSTEM

The Passport System streamlines the process for filing prospectuses, registration, continuous disclosure requirements, and applications for prospectus exemptions.

ELECTRONIC DATABASES

The CSA has developed four electronic databases to streamline regulatory processes and make information more easily available to the market. They are:

- System for Electronic Document Analysis and Retrieval (SEDAR)
- System for Electronic Disclosure by Insiders (SEDI)
- National Registration Database (NRD)
- Cease Trade Order (CTO) National Database

SEDAR is an electronic filing system and a depository for mandatory regulatory filings such as prospectuses. Documents filed on SEDAR are electronically communicated to all CSA members and SEDAR is available to the investing public at www.sedar.com.

SEDI allows insiders to file insider reports in electronic format over the internet. Insiders can file reports with all CSA regulators through a single submission and the public can access insider reports soon after they are filed through the SEDI website at www.sedi.ca.

NRD is the database that allows dealers, underwriters, advisers, and individuals to submit registration applications, changes, and fees electronically. Registrants can send a single submission to all of the securities regulators through NRD at www.nrd.ca.

CTO is the national database for cease trade orders (CTO). A cease trade order (CTO) is an order issued by a securities regulator against a company for failing to meet disclosure requirements, such as filing a quarterly or annual financial statement, or as a result of an enforcement action that involves an investigation of wrongdoing. The order prohibits trading in that company's securities. The CTO database can be found on the CSA website at www.securities-administrators.ca.

NATIONAL INSTRUMENTS

Securities regulation in Canada includes a number of largely harmonized national or multilateral instruments developed under the umbrella of the CSA. These instruments cover a wide range of subjects. The National Instruments most critical to the exempt market include:

- National Instrument 45-106: Prospectus and Registration Exemptions
- National Instrument 31-103: Registration Requirements, Exemptions and Ongoing Registration Obligations

NI 45-106	NI 31-103
NI 45-106 (Prospectus and Registration Exemptions) establishes exemptions from the prospectus requirement. The instrument also defines who can issue securities without being registered as a dealer.	NI 31-103 (Registration Requirements, Exemptions and Ongoing Registration Obligations) establishes the harmonized rules for the registration of firms and individuals. The instrument sets out the requirements for exempt market dealers concerning proficiency, conduct, capital, and compliance with securities regulations. NI 31-103 clearly establishes that exempt market dealers are subject to the same know your client (KYC) and suitability requirements as other dealer categories.

CLIENT RELATIONSHIP MODEL AND CLIENT FOCUSED REFORMS

Under the Client Relationship Model (CRM), harmonized legislation has been enacted under National Instrument (NI) 31-103 (Registration) governing:

- Relationship Disclosure Information (RDI)
- Conflicts of Interest
- Suitability Assessment
- Reporting to Clients

Further amendments to the rules and legislation concerning conflicts of interest, suitability, and Relationship Disclosure Information (RDI) have since been enacted under the Client Focused Reforms (CFR).

Client Relationship Model (CRM) and Client Focused Reforms (CFR)	
Relationship Disclosure Information (RDI)	• CRM introduced the Relationship Disclosure Information (RDI) requirement> • The RDI must be provided to clients to provide them with key information about the account they open at the time they open the account. • The standards for Relationship Disclosure Information (RDI) have since been amended further under the Client Focused Reforms (CFR) which requires registrants to: ◦ include specific disclosure about conflicts of interest ◦ disclose the registered firm's obligation to put the client's interests first when making a suitability determination
Conflicts of Interest	• CRM introduced higher standards for the treatment of conflicts of interest which established that conflicts of interest must be: ◦ addressed in a fair, equitable, and transparent manner, consistent with the best interests of the client • The standards for the treatment of conflicts of interest have since been amended further under the Client Focused Reforms (CFR) which require that registrants must: ◦ address all material conflicts of interest in the best interest of the client ◦ avoid all material conflicts of interest where the conflict cannot be addressed in the best interest of the client
Enhanced Suitability Assessment	• CRM introduced new standards and suitability "triggers" for assessing the suitability of investment products and strategies. • The standards for Know Your Client, Know Your Product, and Suitability Determination have since been amended further under the Client Focused Reforms (CFR) which requires registrants to: ◦ put the client's interests first when making a suitability determination ◦ disclose, in the RDI provided to clients, the registered firm's obligation to put the client's interests first when making a suitability determination
Reporting to Clients	• CRM introduced new standards for reporting to clients as summarized below: ◦ Trade Confirmations: must be issued to clients for each trade and must include prescribed details about the costs and charges. ◦ Account Statements: must be issued to clients on a quarterly basis and in each month that there is activity in the account, and must include prescribed details about position cost, market value, deferred sales charge (DSC) indicators, and other information and disclosures. ◦ The Report on Charges and Compensation: must be issued to clients annually and must provide clients with easy-to-understand information about the amounts, in dollars and cents, of the charges and compensation paid to the dealer. ◦ The Performance Report: must be issued to clients annually and must provide clients with easy-to-understand information about the cost-adjusted performance return of their investments following prescribed standards.

Client Relationship Model (CRM) and Client Focused Reforms (CFR)	

Pre-Trade Cost Disclosure	• CRM introduced the new standard for pre-trade cost disclosure.
	• Registered individuals, including the Dealing Representatives of exempt market dealers, are required to disclose:
	  ◦ the costs associated with the purchase or sale of a security before the transaction is made
	  ◦ whether there are any investment fund management expense fees or other ongoing fees that the client may incur in connection with the security

SELF-REGULATORY ORGANIZATIONS

The securities commissions have delegated powers to a number of self-regulatory organizations (SROs). An SRO is an organization that has been given the authority and responsibility to regulate its members. SROs in Canada include the:

- Investment Industry Regulatory Organization of Canada (IIROC)
- Mutual Fund Dealers Association of Canada (MFDA)
- Chambre de la sécurité financière (CSF)
- Bourse de Montréal

The SROs are accountable to the securities commissions, they must comply with the terms of their recognition order, their rules must be approved by the securities commissions, and they are subject to periodic inspection by the securities commissions.

The members of the SROs must:

- become registered with the securities commissions; and
- become members of the SRO.

For example, investment dealers must be registered with the securities commissions and they are required to become members of the Investment Industry Regulatory Organization of Canada (IIROC). Mutual fund dealers must be registered with the securities commissions and must become members of the Mutual Fund Dealers Association of Canada (MFDA), with the exception of those dealers who explicitly operate solely in the province of Québec.

The SROs have oversight over their members, generally dealers. The securities commissions directly regulate other market participants including issuers, investment counsel/portfolio managers, and investment fund managers. In addition, the securities commissions directly regulate exempt market dealers. No SRO has been formed to regulate exempt market dealers.

In addition to exempt market dealers, investment dealers (IIROC members) are permitted to transact business in the exempt markets. However, mutual fund dealers (MFDA members) are not permitted to transact business in the exempt markets. In order to do so, a mutual fund dealer would be required to become registered as an exempt market dealer and some mutual fund dealers have done so.

SROs have the authority to establish rules and regulations and to discipline participants who do not comply with those rules and regulations. Dealers and their Dealing Representatives who transgress the rules of their SRO expose themselves to a range of penalties including:

- fines
- suspension of a dealer or an individual
- permanent termination of a dealer or permanent prohibition of an individual
- other penalties, such as:
  - a reprimand
  - conditions such as the requirement to re-write an exam or an industry course
  - terms and conditions on the membership of a dealer
  - the appointment of a monitor to oversee that the dealer brings their firm to full compliance
  - directions for the orderly transfer of client accounts from a dealer

EXAMPLE

Celia Burnside misrepresented her financial credentials, claiming she had an advanced degree in finance, in both her application for registration and in her marketing materials. The IIROC hearing panel invoked the following penalties: her registration approval was revoked and Celia was ordered to pay a fine of $15,000.00.

INVESTMENT INDUSTRY REGULATORY ORGANIZATION OF CANADA

The Investment Industry Regulatory Organization of Canada (IIROC) is the SRO with oversight for investment dealers in Canada.

IIROC's mission is to:

- Protect investors
- Foster market integrity
- Enhance the efficiency and competitiveness of the Canadian capital markets

IIROC's mandate includes:

- Registration
- Financial Compliance
- Business Conduct Compliance
- Enforcement
- Regulatory Policy

MUTUAL FUND DEALERS ASSOCIATION OF CANADA

The Mutual Fund Dealers Association of Canada (MFDA) is the SRO with oversight for mutual fund dealers, with the exception of those dealers who reside and solely operate in the province of Québec.

The MFDA's mission is to:

- Enhance investor protection
- Strengthen public confidence in the Canadian mutual fund industry

The MFDA's mandate includes:

- Financial Compliance
- Business Conduct Compliance
- Enforcement
- Regulatory Policy

IIROC and MFDA Mandates		
Mandate	**Details**	**SRO**
Registration	• Screening applicants for registration with the securities commission • Ensuring representatives entering the industry are of good character and have the necessary proficiencies	IIROC
Financial Compliance	• Conducting audits of members to ensure that they maintain adequate capital and insurance • If found deficient, invoking remedial action which could include the suspension of the firm's trading privileges	IIROC & MFDA
Business Conduct Compliance	• Conducting audits of members to ensure that they have effective procedures in place to supervise the handling of client accounts, including suitability: ○ Firms are required to document in full the "Know Your Client" (KYC) information for clients including investment needs and objectives and risk profile, and to ensure that investment products and strategies are suitable for clients and in keeping with those factors	IIROC & MFDA
Enforcement	• Conducting investigations of complaints • Conducting investigations of non-compliance with SRO rules and securities regulations/legislation detected by means other than complaints (e.g. compliance audits) • Prosecuting firms and individuals at hearings and imposing penalties including fines, suspension, and termination/prohibition	IIROC & MFDA
Regulatory Policy	• Establishing new rules and regulations • Updating and amending existing rules and regulations	IIROC & MFDA

CHAMBRE DE LA SÉCURITÉ FINANCIÈRE

In Québec, the AMF regulates mutual fund dealers and it has recognized the Chambre de la sécurité financière (CSF) as the SRO to regulate mutual fund representatives. The MFDA has a cooperative agreement with the AMF and the CSF which covers matters such as information sharing, inspections, the harmonization of rules and regulations, enforcement, and complaints.

BOURSE DE MONTRÉAL

The regulatory division of the Bourse de Montréal is recognized as the SRO responsible for the market surveillance of Canada's main derivatives exchange.

EXEMPT MARKET DEALERS REGULATION

Like the SRO members of IIROC and the MFDA, exempt market dealers are subject to regulatory requirements with respect to:

- registration
- capital requirements and financial condition
- internal controls and compliance
- dealing with clients and business conduct
- handling client accounts and client reporting

The requirements applicable to exempt market dealers are established in National Instrument 31-103 and the securities commissions have oversight of the exempt market dealers. Similar to the SROs, the mandate of the securities commissions for exempt market dealers includes:

- Registration
- Financial Compliance
- Business Conduct Compliance
- Enforcement
- Regulatory Policy

The securities commissions conduct audits of exempt market dealers to ensure their compliance with capital requirements and business conduct requirements, including KYC and suitability. The securities commissions also conduct investigations of complaints and non-compliant activity and where transgressions are proven, they prosecute exempt market dealers and impose penalties including fines, suspension, and termination/prohibition.

AUTHORITY OF THE SECURITIES REGULATORS AND SROS

Securities commissions and SROs have the authority to discipline participants who engage in improper conduct. However, they are not empowered to order or obtain restitution for investors who have lost money. Investors may seek restitution for investment losses through other means and bodies, including the Ombudsman for Banking Services and Investments (OBSI).

Registration Requirements 2

CONTENT AREAS

INTRODUCTION

This lesson focuses on the securities regulations with respect to registration and the requirements established in National Instrument 31-103: Registration Requirements, Exemptions and Ongoing Registration Obligations (NI 31-103).

This lesson takes approximately 30 minutes to complete.

LEARNING OBJECTIVES

At the end of this lesson, you will be able to:

1 | Explain the registration requirement and when it is required.

2 | Discuss registration jurisdiction.

3 | Discuss registration categories for firms and Dealing Representatives.

4 | Describe the qualifications for registration.

5 | Discuss registration approval and refusal.

6 | Describe the notification of registration changes.

7 | Discuss conditions where registration is suspended or revoked.

8 | Discuss the impact of National Instrument 31-103 on the exempt market and the Northwest exemption.

REGISTRATION IS OF CRITICAL IMPORTANCE

Entering into the investment industry as a Dealing Representative can be an exciting and rewarding career. However, entrance into the capital markets requires registration under the securities regulators. It is essential that Dealing Representatives fully understand the registration process since it will determine:

- ***when*** they can conduct business in investment products
- ***what*** specific investment products they may deal in
- ***what*** specific activities and business dealings they may carry out
- ***where*** they may conduct business

There are 2 important factors in the registration process:

1. Registration of the firm
2. Registration of the individual

The registration of both the firm and the individual determine when, where, and what a Dealing Representative can do.

WHEN REGISTRATION IS REQUIRED

Under securities legislation, every firm and individual must be registered if they are in the business of trading or advising in securities. In order to conduct business in investment products, you must first become registered as a Dealing Representative with the securities regulators. Your dealer firm will become registered first and then they will sponsor your registration. You may not, under any circumstances, open client accounts or offer investment products to clients unless your registration has first been approved by the securities regulators.

GETTING REGISTERED

Once you are ready to become registered as a Dealing Representative, you must prepare yourself for the application process and then apply for registration with the securities regulators. In order to apply for registration, you must:

- Determine the jurisdiction(s) where you will conduct business
- Determine your category of registration
- Obtain the qualifications for registration
- Complete and submit an application for registration
- Be approved by the securities commissions/regulators

REGISTRATION JURISDICTION

There is a securities commission/regulator for each of the provinces and territories in Canada. Before you can conduct business as a Dealing Representative in any given province or territory, you must apply to the securities regulator in that jurisdiction and be granted registration approval.

Both your dealer firm and you need to be registered in the province/territory. In cases where your dealer firm is not registered in a particular province or territory, you cannot seek registration, open client accounts, or offer investment products in that jurisdiction.

Registration Jurisdiction
13 securities commissions/regulators: • One in each of the provinces and territories in Canada

REGISTRATION CATEGORY

When determining which registration category you want to apply for, you need to consider 2 factors:

1. Registration category of your firm
2. Registration category for you

Firms can be registered under 6 different categories. Individuals can be registered under 9 different categories including those that open client accounts and offer investment products to clients, such as Dealing Representatives, and registrants who carry on other activities for their firm including supervision and portfolio management.

Firm Registration Category	Individual Registration Categories
6 firm categories: • Investment Dealer • Mutual Fund Dealer • Exempt Market Dealer • Scholarship Plan Dealer • Portfolio Manager • Investment Manager	9 individual categories: • Dealing Representatives • Other categories

Both the registration category of your firm and your individual registration category will determine:

- ***what*** specific investment products you may deal in
- ***what*** specific activities and business dealings you may carry out

REGISTRATION CATEGORIES FOR FIRMS

Dealing Representatives are restricted to the investment products and activities dictated under their firm's registration category. The registration categories for firms and their corresponding permitted investment products and activities are summarized in the table below.

Registration Categories for Firms	
Registration Category	**Permitted Activities**
Investment Dealer	• Trading or acting as a dealer or an underwriter in respect of any security • Investment dealers must become members of IIROC
Mutual Fund Dealer	• Trading only in securities of mutual funds, exchange-traded funds, investment funds that are labour sponsored investment corporations or labour sponsored venture capital corporations, and deposit products such as GICs and PPNs • Mutual fund dealers must become members of the MFDA
Exempt Market Dealer	• Acting as a dealer in the "exempt market" under NI 45-106 *Prospectus and Registration Exemptions* • Trading in prospectus-exempt securities to specified clients including "accredited investors" and "eligible investors"
Scholarship Plan Dealer	• Trading only in securities of scholarship plans, educational plans, or educational trusts
Portfolio Manager	• Advising, investing in, buying or selling any type of security, with or without discretionary authority granted by the investment fund/client to manage the investment fund's/client's portfolio
Investment Fund Manager	• Directing the business, operations, or affairs of an investment fund • Managing the business activities of the investment fund other than the function of portfolio management

DEALING REPRESENTATIVE CATEGORY

Individuals who act on behalf of a registered dealer must be registered as Dealing Representatives. Dealing Representatives are permitted to sell, distribute, and trade in the securities that are permitted under their firm's registration.

EXAMPLE
Lakeshore Investments Inc. is registered as a Mutual Fund Dealer and Peter Harper is registered as a Dealing Representative for Lakeshore. Peter may open client accounts and offer mutual funds to clients. However, Peter is restricted from offering other investment products to clients, for example exempt market securities. As a rule, even if you have passed the requisite proficiency exams for exempt market securities, if your firm has not been registered as an exempt market dealer, then you may not seek registration to provide exempt market products or be approved to offer those investments to clients. **Both** the firm and the individual must be registered under the appropriate registration category in order to conduct business in specific investment products.

Dealing Representatives of exempt market dealers are restricted from offering securities of publicly listed companies. For example, the Dealing Representative of an exempt market dealer would be restricted from trading common shares that trade on a stock exchange. If you are unsure whether you are able to offer an investment product to a client, you should always check with your dealer firm first.

QUALIFICATIONS FOR REGISTRATION

In order to qualify for registration as a Dealing Representative, you will need to satisfy the regulatory requirements governing:

- Proficiency
- Integrity
- Solvency

PROFICIENCY

Participants in the capital markets are subject to proficiency requirements as a condition of registration. As a Dealing Representative, you are expected to:

- have the necessary education, training, and experience

In order to satisfy these proficiency requirements, you are required to:

- successfully pass the necessary qualifying exams
- satisfy the conditions related to experience (where applicable)

To become eligible to apply for registration as a Dealing Representatives for an exempt market dealer (EMD), you must:

- successfully pass the *Exempt Market Proficiency Exam*; or
- successfully pass the *Canadian Securities Course Exam*; or
- satisfy one the conditions under section 3.9 of NI 31-103 pertaining to CFA and/or portfolio manager proficiencies.

Proficiency	• Educational, professional, and experience prerequisites • Found in Part 3 of National Instrument (NI) 31-103

INTEGRITY

Participants in the capital markets are held to the highest standards of conduct, particularly when dealing with clients. As a Dealing Representative, you are obligated to conduct yourself with integrity and to deal with clients honestly and in good faith.

All registrants in the securities industry are obligated to comply with securities legislation. As a Dealing Representative, you are subject to the securities laws, regulations, and other applicable legislation governing your registration and business activities.

Integrity	• Standard of Conduct • Honesty and good faith when dealing with clients • Compliance with securities laws, regulations, and other legislation

SOLVENCY

Participants in the capital markets are held to standards governing their financial condition and insurance. Dealing Representatives are expected to be in sound financial condition.

Solvency	• Financial condition • Insurance

APPLICATION FOR REGISTRATION

Once you have successfully completed the proficiency exams and you have met the qualifications for registration, you are ready to apply for registration. You must complete the application documents which include:

- *Form 33-109F4 (Registration of Individuals and Review of Permitted Individuals*)
- If your dealer is a member of an SRO (such as the MFDA), certain documents required by the SRO
- Documents required by your dealer firm including those for outside business activities, dual occupations, agency agreements, etc.

The securities regulators also charge fees for granting registration. The amount of the registration fee payable can be found on the websites of the securities regulators.

In order to determine if you are fit for registration, the securities regulators and your dealer firm will conduct a thorough examination including background checks on your personal circumstances, proficiency exam results, employment history, registration history, criminal history, and financial condition including garnishments, unsatisfied judgments, and bankruptcy.

REGISTRATION APPROVAL

If your registration is approved, notification of approval will be sent to you by email and your registration will be displayed on the website of the securities regulator(s).

REFUSAL OF REGISTRATION

The securities regulators may deny registration to any firm or individual that may pose a risk to investors and/or the capital markets. If a firm or an individual fails to satisfy the standards for proficiency, integrity, and/or solvency, the securities regulators may deem the applicant not fit for registration and their registration may be refused.

EXAMPLE

Solvency

Marsha Block applies to become a Dealing Representative for an exempt market dealer, EMD Investments Inc. However, Marsha has filed for bankruptcy. Under these circumstances, the securities commission denies Marsha's registration application. Securities regulators would likely consider an individual with poor finances to be unfit for registration. Dealing Representatives are obligated to engage in business that is influenced only by the best interests of their clients. Where a Dealing Representative is found to be in financial trouble, there could be the risk that the Dealing Representative would consider their own financial needs ahead of the best interests of their client.

EXAMPLE

Integrity

Greg Walkman applies to become a Dealing Representative for an exempt market dealer, ARC Investments Corp. However, Greg has a criminal record for insurance fraud. Under these circumstances, the securities commission denies Greg's registration application. Securities regulators would most probably find an individual with a criminal record to be unfit for registration. Where an individual has already demonstrated non-compliance to laws under the criminal code, the potential for them to fail in their obligations under securities laws could pose a risk to investors and/or the capital markets.

CHANGES TO REGISTRATION INFORMATION

Once registered, you are required to notify the securities regulator(s) if there are any changes to the registration information you previously provided.

Changes to Registration Information
Individual Registrants (including Dealing Representatives)

Changes must be filed with the securities regulator(s) within 10 days of the date of the change for the following:

- name
- residential address
- citizenship
- registration Jurisdictions
- individual registration categories
- address and agent for service
- proficiency
- location of employment
- current employment, other business activities, officer positions held, and directorships
- previous employment and other activities
- resignations and terminations
- regulatory disclosure
- criminal disclosure
- civil disclosure

Changes to Registration Information Individual Registrants (including Dealing Representatives)
• financial disclosure • ownership of securities and derivatives firms • registrant position or relationship with sponsoring firm • permitted individual status • name of sponsoring firm, status of registration, terms and conditions (if applicable)

Exempt market dealers must also notify securities regulators of any changes to their registration status.

Changes to Registration Information Exempt Market Dealers
Changes must be filed with the securities regulators within 10 days of the date of the change for the following: • change in the dealer's agent and address for service of process • change in business address of the dealer (including the opening and closing of a business location) • change in or termination of the directors or officers of the dealer, or the termination or cessation of authority of the dealer's registered or permitted individuals (including CCO, UDP and Dealing Representatives) and the reason for the resignation, dismissal, severance or termination of employment or office • change to the information on the dealer's Form 33-109F6 other than business history and structure, but including changes in financial year-end and auditors, etc. • application for a review of a permitted individual (seven days after the appointment of the permitted individual)
Changes must be filed with the securities regulators within 30 days of the date of change for the following: • change in business history and structure (including any change in the holders of the voting securities of the dealer; notification of or changes to trade names) • details regarding any change in or termination of the directors or officers of the dealer, or the termination or cessation of authority of a registered or permitted individual of the dealer (including the CCO, UDP, and Dealing Representatives). These details do not need to be filed where the termination was due to the expiry of a temporary employment contract, retirement or death.

The securities regulator may impose a penalty fee for the late filing of notices of change. For example, in Ontario the fee is $100 per business day (subject to a maximum of $5,000 for all documents within one financial year).

REGISTRATION REINSTATEMENT WHEN CHANGING DEALERS

If you leave a sponsoring firm (for example an exempt market dealer) and then you seek automatic reinstatement of your registration at a new firm under the same registration category (in this case another exempt market dealer), you must do so within 90 days of the date that your employment ceased with the first firm and you must be applying for registration in the same jurisdiction.

EXAMPLE

Phil Ng is leaving Anaka Partners to start as a Dealing Representative at a new firm within 30 days. Anaka files a Notice of Termination of Registered Individuals and Permitted Individuals on the NRD. Because Phil is not changing his registration category, and the new dealer is registered in the same category and jurisdiction as Anaka, the new firm files Form 33-109F7 Reinstatement of Registered Individuals and Permitted Individuals for automatic transfer. This allows Phil to start trading from the first day.

ANNUAL FILINGS

Under NI 31-103, an exempt market dealer's registration is considered permanent unless cancelled, surrendered, or suspended by either the firm or the securities regulator(s). Dealers are not required to renew registration annually, however, the dealer is required to pay certain fees and file certain forms to maintain its registration in the provinces and territories where it is registered. In addition to the fees payable to each of the securities regulators, the dealer must also pay an annual user fee to the National Registration Database (NRD) for each registered individual of the firm listed on the NRD system. These fees are due on December 31st of each year, paid in advance for the following year.

WHEN REGISTRATION MAY BE SUSPENDED OR REVOKED

A registered firm or individual may carry on registered activities until their registration is suspended automatically, suspended by the regulator, or surrendered. If registration is suspended, the firm/individual is no longer permitted to carry on registered activities. A suspension remains in effect until the regulator either reinstates or revokes the registration.

When a securities regulator revokes registration, this terminates the registrant's registration for all purposes. The regulator may not revoke, suspend, or impose terms and conditions on a registrant without giving the firm/individual an opportunity to be heard.

If a previously registered firm or individual wants to register again, they must submit a new application for registration.

Registration is **automatically suspended** if:

- the annual fee to the securities regulator remains unpaid by the registrant for more than 30 days after the due date
- an SRO suspends or terminates a firm's membership
- an SRO revokes or suspends an individual's approval as a representative of a registered dealer

Registration of an individual will be **automatically suspended** if:

- the individual's sponsoring firm is suspended
- the individual's employment with the sponsoring firm is terminated
- the individual's employment functions change
- the partnership or agency relationship between the individual and their sponsoring firm changes or is terminated
- in the case of a CCO or UDP, the individual ceases to be the CCO or UDP of their sponsoring firm

IMPACT OF NI 31-103 ON EXEMPT MARKET DEALERS

Prior to NI 31-103, it was possible to sell exempt securities without being registered as a dealer in most jurisdictions. With the exception of the limited market dealer category in Ontario and Newfoundland and Labrador, exempt securities could be offered to investors outside of dealer registration requirements. When NI 31-103 was enacted, the instrument introduced a business trigger for registration, the harmonization of registration requirements and categories, and the creation of new firm and individual categories. NI 31-103 was a watershed event affecting the participants in the exempt market. Under NI 31-103, requirements were established that required firms that offered exempt securities to investors to become registered under a new dealer category: exempt market dealer. The exempt market dealer category also replaced the former limited market dealer category in Ontario and Newfoundland and Labrador. Following the enactment of NI 31-103, the exempt market dealer category was adopted by all jurisdictions.

NORTHWEST EXEMPTION[1]

When NI 31-103 came into effect, certain jurisdictions adopted an exemption to the exempt market dealer registration requirement. Alberta, British Columbia, Manitoba, Saskatchewan, the Northwest Territories, Nunavut, and the Yukon Territory each issued a blanket order exempting individuals and firms from the dealer registration requirement for trades in exempt securities where they are offered under one of the following prospectus exemptions in NI 45-106:

- accredited investor exemption
- minimum purchase exemption (where an investor invests $150,000 or more in a single transaction)
- offering memorandum exemption
- family, friends, and business associates exemption

To rely on a blanket order, an individual or firm must:

- not be registered in any category of registration in any jurisdiction
- not provide suitability advice about the trade to the purchaser
- not otherwise provide financial services to the purchaser
- not hold or have access to the purchaser's assets
- provide risk disclosure in the prescribed form to the purchaser
- file an information report with the securities commission/regulator

Under reliance of the blanket order, certain individuals and firms that satisfy all the above conditions are not required to become registered as an exempt market dealer.

[1] Note: Effective April 30, 2019, the securities regulators of all provinces and territories have revoked the Northwest Exemption, with the exception of Alberta and Saskatchewan.

UNIT SUMMARY

Congratulations, you have reached the end of Unit 2: Regulatory Framework.

In this unit you covered:

- Lesson 1: Regulatory Environment
- Lesson 2: Registration Requirements

Now that you have completed these lessons, you are ready to assess your knowledge with a 10-question quiz. To start the quiz, return to the IFSE Landing Page and click on the Unit 2 Quiz button.

UNIT 3

COMPLIANCE FOR EXEMPT MARKET DEALERS

INTRODUCTION

In this unit you will learn about compliance for exempt market dealers.

This unit takes approximately 1 hour to complete.

Lessons in this unit:

1. The Compliance Regime
2. Compliance Duties of Exempt Market Dealers
3. Compliance with Other Legislation and Regulations

The Compliance Regime 1

CONTENT AREAS

Compliance Requirements
Training and Education
Key Compliance Personnel
CCO Annual Report to the Board of Directors

INTRODUCTION

This lesson introduces you to the key elements of the exempt market dealer's compliance regime. In this lesson, you will learn about the requirement for exempt market dealers to establish a compliance system and monitor its effectiveness on an ongoing basis.

This lesson takes approximately 10 minutes to complete.

LEARNING OBJECTIVES

At the end of this lesson, you will be able to:

1 | Explain the key elements of the compliance regime.

2 | Explain the firm's responsibility for training and education.

3 | Explain the role of key compliance personnel.

4 | Describe the key components of the CCO Annual Report.

COMPLIANCE REQUIREMENTS

Registered firms are responsible for all business conducted through their firms and for ensuring that the requirements established in applicable legislation and regulations are satisfied. Therefore, it is incumbent upon all registered firms to develop and operate an effective compliance regime.

Registered firms are subject to legislation and regulations which requires that they establish an effective compliance regime. National Instrument 31-103 (NI 31-103) section 11 requires all registered firms to establish, maintain, and apply a system of controls and supervision sufficient to provide reasonable assurance that:

- the firm complies with securities legislation
- the risks associated with its business are managed in accordance with prudent business practices

Exempt market dealers (EMDs) are subject to the compliance requirements established in securities legislation and regulations, including NI 31-103, and other applicable Canadian legislation and regulations, including those pertaining to anti-money laundering, anti-terrorist financing, privacy laws, and others.

To be effective, the compliance regime should be designed to identify and control the risk of compliance failures that could result in harm to investors and/or the capital markets, or result in financial losses and/or reputational damage to the registered firm. To do this, the program should:

- allocate sufficient resources to support an effective compliance regime
- create measures and systems that encourage and reward compliant behavior and discourage non-compliant behavior
- ensure that the Chief Compliance Officer (CCO) has access to senior management and the board of directors to keep them informed of compliance issues and developments

Key components of the compliance regime are:

- visible commitment to compliance from senior management and the board of directors
- adequate resources committed to compliance including qualified compliance personnel and proper training programs for everyone in the firm

- detailed written policies and procedures
- detailed records of compliance activities

In order to support an effective compliance regime, EMDs can promote a culture of compliance and set the appropriate tone at the top levels of the firm by:

- clearly identifying, prioritizing, and communicating compliance goals
- establishing high ethical standards
- leading by example at the management level
- making the effective execution of compliance at the supervisory level an explicit element of compensation and promotion decisions
- committing adequate resources to the compliance function
- sharing important information with compliance personnel so they can carry out their responsibilities
- developing cooperative relationships with securities regulators and other regulatory authorities

A common misconception is that compliance is solely the responsibility of the compliance department. In fact, compliance is a firm-wide responsibility. Everyone within the firm has a responsibility to observe high standards of conduct and to comply with legislation and regulations. To ensure that compliance is promoted at all levels of the firm, an EMD should:

- ensure that everyone in the firm has a clear understanding of the role of compliance
- regularly communicate compliance information to everyone in the firm
- emphasize compliance and regulatory subjects in ongoing training
- provide a means of communicating any compliance or ethical concerns to everyone in the firm (confidential or anonymous, without fear of reprisal)
- allocate appropriate development, training, and remuneration resources to the compliance function in order to hire and retain key compliance personnel
- implement internal disciplinary measures for non-compliant behavior

Compliance should not be viewed as an isolated activity, but as an integral part of the EMD's general business activities.

TRAINING AND EDUCATION

Overseeing the training and education of registered individuals is a component of the exempt market dealer's compliance program. These responsibilities begin with the verification of proficiency requirements at the time of an individual's registration, followed by the training of newly registered persons under some provincial/territorial requirements, and continues through the duration of the individual's registration with the firm. The Compliance function for the firm is often charged with the responsibility for tracking to ensure that training is completed. In addition, all registered firms are required to establish a specific compliance training program for it's registered individuals under securities legislation and privacy legislation.

Summarized below are the key elements of a registered firms training and education program that would normally fall under the responsibility of Compliance.

Training and Education	
Training	**Description**
New Registrants	• training for newly registered individuals

Compliance Training (prescribed under securities legislation)	The registered individuals' obligations and the firm's policies and procedures with respect to:
	• Know Your Client (KYC)
	• Know Your Product (KYP)
	• Suitability
	  ◦ including how to fulfill the requirement to put the client's interest first when making a suitability determination
	• conflicts of interest
	  ◦ including how to fulfill the requirement to identify and address material conflicts of interest
	• changes to regulatory requirements
	• changes to policies and procedures
	• any additional training on specific investment products identified under the due diligence review of the product

Anti-Money Laundering and Terrorist Financing (AMLTF)	• ongoing compliance training program on anti-money laundering and terrorist financing for all compliance personnel and all registered persons and employees who deal with cash and deposits
	  ◦ before they assume their duties
	  ◦ periodically thereafter as established in the firm's policies and procedures (e.g. every 2 years, annually, as applicable)

Personal Information Protection and Electronic Documents Act (PIPEDA) (and similar provincial legislation)	• privacy training for all registered persons and employees

KEY COMPLIANCE PERSONNEL

While compliance is an enterprise-wide responsibility, EMDs must designate qualified individuals who have specific compliance responsibilities including the:

- Ultimate Designated Person (UDP)
- Chief Compliance Officer (CCO)
- Board of Directors
- Compliance Personnel and Branch Managers

The responsibilities of the key compliance personnel are summarized in the table below.

<table>
<tr><th colspan="2">Key Compliance Personnel</th></tr>
<tr><th>Designated Person</th><th>Responsibilities</th></tr>
<tr><td>Ultimate Designated Person (UDP)</td><td>supervise the activities of the firm to ensure compliance with securities legislation and regulations
promote compliance with securities legislation and regulations by the firm</td></tr>
<tr><td>Chief Compliance Officer</td><td>establish and maintain policies and procedures for assessing the firm's compliance with securities legislation and regulations
monitor and assess the firm's compliance with securities legislation and regulations
report circumstances of non-compliance to the UDP where the non-compliance:
creates a risk of harm to a client
creates a risk of harm to the capital markets
represents a pattern of non-compliance
submit an annual report to the firm's board of directors for the purpose of assessing the firm's compliance with securities legislation and regulations</td></tr>
<tr><td>Board of Directors</td><td>must permit their UDP and CCO to have direct access to the Board of Directors at such times as the UDP or CCO may deem necessary or advisable given their responsibilities
responsible to act based on reports from the UDP and CCO</td></tr>
<tr><td>Compliance Personnel and Branch Managers</td><td>perform supervisory reviews to:
monitor and assess business activities
identify exceptions
remedy exceptions
maintain records of supervisory reviews
escalate instances of non-compliance to their managers/the CCO where required</td></tr>
</table>

CCO ANNUAL REPORT TO THE BOARD OF DIRECTORS

Section 5.2(d) of NI 31-103 establishes that the CCO submit an annual report to the firm's board of directors for the purpose of assessing compliance with securities legislation. The key components of the CCO's annual report are summarized in the table below.

CCO Annual Report to the Board of Directors

The CCO's Annual Report to the board of directors should include (at minimum):

- all complaints and referrals received by the firm
- any regulatory or legal proceedings
- all internal investigations and findings
- status of branch reviews (where applicable)
- status of service providers
- any changes to regulatory requirements in the previous year affecting the firm
- compliance bulletins issued
- changes to compliance procedures
- update on audits/auditors (internal/external)
- compliance resources
- any changes from the previous report
- any other material matter(s) relevant to the assessment of compliance

Compliance Duties of Exempt Market Dealers

2

CONTENT AREAS

INTRODUCTION

This lesson covers the compliance duties of exempt market dealers (EMDs).

This lesson takes approximately 30 minutes to complete.

LEARNING OBJECTIVES

At the end of this lesson, you will be able to:

1 | Discuss written policies and procedures.

2 | Explain the compliance function.

3 | Discuss business conduct compliance and financial compliance.

4 | Explain books and records.

5 | Explain client reporting.

6 | Discuss advertising and marketing.

7 | Explain the complaint handling process.

8 | Describe regulatory reviews and audits.

9 | Discuss the elements of outsourcing.

WRITTEN POLICIES AND PROCEDURES

Exempt market dealers (EMDs) are required to establish, maintain, and apply policies and procedures that establish a system of controls and supervision. Detailed written policies and procedures are the foundation of an effective compliance system, documented in the EMD's *Policies and Procedures Manual*. The *Policies and Procedures Manual* should:

- establish internal controls to monitor risk
- establish standards of conduct
- clearly outline supervisory procedures
- be easily accessible to everyone who is expected to know and follow the policies and procedures
- be updated when regulatory requirements or business practices change
- consider the obligation to deal fairly, honestly, and in good faith with clients

The firm's policies and procedures must take into consideration the firm's obligation to:

- deal fairly, honestly, and in good faith with clients
- address conflicts of interest in the best interests of clients
- put the client's interest first when making suitability determinations for clients

As a Dealing Representative, you must know your EMD's policies and procedures and stay informed about compliance updates as they are communicated. As a condition of your registration as a Dealing Representative, you are expected to be current and up to date on your regulatory obligations and your EMD's policies and procedures.

COMPLIANCE FUNCTION

EMDs are required to apply the policies and procedures documented in their *Policies and Procedures Manual* and establish a system of controls and supervision to ensure that the firm:

- complies with securities legislation
- manages the risks associated with its business in accordance with prudent business practices

This supervision mandate is referred to as the **"compliance"** function and is generally comprised of 2 distinct areas of compliance:

- business conduct compliance (also known as "sales compliance")
- financial compliance

Compliance Function	
Compliance Mandate	**Internal Controls**
Business Conduct Compliance (or Sales Compliance)	Focused on the business activities conducted by the EMD and each individual acting on the firm's behalf: • business conducted by Dealing Representatives • new client accounts • trading and the distribution of securities to clients • Know Your Client, Know Your Product, and suitability • marketing and sales practices • conflicts of interest • books and records (for business conduct)
Financial Compliance	Focused on the EMD's financial position, capital, and insurance: • rules that mitigate the risk of insolvency of the firm • protecting customer cash and securities • safeguarding firm assets • books and records (for the finances of the EMD)

BUSINESS CONDUCT COMPLIANCE

EMDs are required to designate staff responsible for conducting supervisory reviews of the day-to-day business activity conducted at their firm. The compliance staff designated to this supervisory function monitor business activity for compliance with securities regulations with the purpose of detecting non-compliant activity, unusual activity, or undesirable business practices.

As established in National Instrument 31-103 (NI 31-103), Companion Policy (CP), Part 11.1 (Compliance System (a) Day-to-Day Monitoring) business conduct compliance encompasses day-to-day monitoring and supervision including:

- monitoring to identify specific cases of non-compliance or internal control weaknesses that might lead to non-compliance
- referring non-compliance or internal control weaknesses to management or other individuals with authority to take supervisory action to correct them

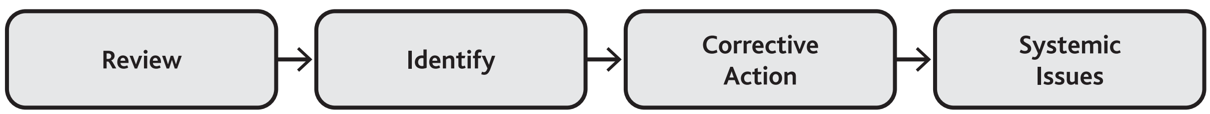
- taking supervisory action to correct them, and
- minimizing the compliance risk in key areas of a firm's operations

As per NI 31-103, effective day-to-day monitoring includes:

- approving new account documents
- reviewing transactions
- reviewing marketing materials
- preventing inappropriate use or disclosure of non-public information

Where exceptions are identified, the compliance staff are responsible for taking corrective measures to remedy any exceptions identified and/or escalating issues to a higher level where required. Steps must also be taken to address any systemic issues in order to continually minimize compliance risk in the EMD's business operation.

Figure 3.1



EXAMPLE

During daily supervisory reviews, Kieran, the CCO of Open Air Securities Inc., detects a high number of the client files for George Burns, a Dealing Representative, which have incomplete Know Your Client (KYC) information. Kieran tells George Burns to collect the missing KYC information for all his files. George contacts all his clients, completes the missing KYCs, and submits the completed KYCs to Kieran. Kieran also notices that a new Dealing Representative, Sally Turner, submits incomplete KYCs to her. Kieran tells Sally to collect the missing KYC information for her files and submit the new KYC forms to her. Kieran also updates the firm's Policies and Procedures Manual with specific instructions on completing KYC forms and arranges for training for all Dealing Representatives and supervisors on completing KYC forms.

It is in your best interests, as a Dealing Representative, to run a compliant business practice. Addressing deficiencies is time-consuming and takes away from the time you have for clients. You could also be subject to disciplinary measures, from your EMD or the regulatory authorities, if problems with your business practice are repeated or severe.

FINANCIAL COMPLIANCE

Financial Compliance is focused on the EMD's financial position, capital, and insurance.

FINANCIAL POSITION AND CAPITAL REQUIREMENTS

Securities legislation and regulations require EMDs to maintain minimum capital and calculate and file reports concerning their financial position and capital. The objective of these requirements is to ensure that EMDs have adequate capital and liquidity in order to ensure their ongoing solvency. The ultimate risk associated with insufficient capital is the bankruptcy of the EMD, which may in turn put investors at risk of financial loss.

NI 31-103 section 12 establishes the financial condition, capital, insurance, and audit requirements for EMDs.

The requirements impose regular and periodic filing and reporting obligations on EMDs in order to ensure that the securities regulators have current and accurate information regarding their operations and finances. EMDs calculate and report to their securities regulators using Form 31-103F1 and must maintain "excess working capital" (EWC) not less than zero. Where EWC falls below zero, the registered firm must notify the securities regulator immediately.

INSURANCE REQUIREMENTS

EMDs must obtain bonding and insurance to protect customers' cash and securities and to insure and protect the firm. The insurance requirements for EMDs are established in NI 31-103 (Section 12.3 and Appendix A) and require EMDs to obtain and maintain bonding and insurance to protect against losses including:

- **Fidelity**: dishonest or fraudulent acts of its employees or agents
- **Premises**: robbery, burglary, theft, hold-up or other fraudulent means, mysterious disappearance, damage or destruction
- **In Transit and Mail**: robbery, burglary, theft, hold-up, misplacement, mysterious disappearance, damage or destruction, while in transit or in the mail
- **Forgery or Alterations**: forgery or alteration of any cheques, drafts, promissory notes or other written orders or directions to pay sums in cash
- **Securities**: acquired, sold or delivered, or acted upon securities or other written instruments which prove to have been forged, counterfeited, raised or altered, or lost or stolen, or through having guaranteed in writing or witnessed any signatures upon any transfers, assignments or other documents or written instruments

BOOKS AND RECORDS

EMDs are required to maintain books and records in order to:

- accurately record its:
  - business activities
  - financial affairs
  - client transactions
- demonstrate the EMD's compliance with regulatory requirements and legislation

Books and records must be maintained in a secure location/medium for a minimum of 7 years and must be accessible and available for review by the regulators who have oversight over the EMD.

The records and client files of Dealing Representatives constitute "books and records" of the EMD and are subject to the regulatory requirements concerning books and records. As such, you are required to maintain records and client files that are complete, accurate, and accessible to the regulatory authorities.

CLIENT REPORTING

EMDs have a regulatory obligation to provide clients with reporting which includes:

- trade confirmations
- client account statements
- position cost information
- annual report on charges and other compensation
- investment performance reports

Client Reporting	
Reporting	**Details**
Trade Confirmations	• a written confirmation of a trade (purchase or sale of a security) • details of the trade (e.g. price, quantity, commission/charges, etc.) • promptly following the trade
Client Account Statements	• details of all transactions during the period (e.g. trades, dividends, interest, etc.) • details of all holdings in the account (e.g. quantity and values of cash and securities, etc.) • quarterly (every 3 months) at minimum and for each month that there is a transaction in the account
Position Cost Information	• the cost of each security position and the total cost of all security positions • on the quarterly Client Account Statement
Annual Report on Charges and Compensation	• total amount of all account costs, transaction costs, mark-ups, mark-downs, commissions, service charges, and any other charges/costs • total amount of payments made to the dealer/representative by the securities issuer/registrant • total amount of trailing commissions paid to the dealer/representative annual report
Investment Performance Reports	• the market value of all cash and securities in the client's account as at the end of the 12-month period • the market value of all cash and securities in the client's account as at the beginning of the 12-month period • the market value of all deposits and transfers of cash and securities into the client's account in the 12-month period • the market value of all withdrawals and transfers of cash and securities out of the account in the 12-month period • the annual change in the market value of the client's account for the 12-month period covered by the investment performance report, determined using the following formula: ◦ A – B – C + D • annual report

ADVERTISING AND MARKETING

EMDs are required to ensure that advertising, client communications, and marketing materials are not misleading. Advertising and marketing materials include:

- business cards, letterhead, and signage
- websites, emails, social media, and electronic marketing
- newspapers, newsletters, or other media for publication
- radio or television interviews and conference speeches

- slogans, tag lines, logos, tweets, and blogs
- client communications

As a Dealing Representative, you are prohibited from providing misleading marketing materials to clients and you are required to submit draft materials to your EMD for review. You may only provide marketing materials to clients after the materials have been approved by your EMD.

EMDs are responsible for reviewing advertising and marketing materials to ensure compliance with regulations and to ensure that materials are not misleading.

EXAMPLE

Randy Harris, a Dealing Representative with Abacus Financial Ltd., has redesigned his marketing materials. He submits the draft materials to the EMD's compliance department for review. They will review his materials to ensure, among other things, that the materials do not contain any misleading images, graphics, or statements which provide an unjustified promise of returns.

CLIENT COMPLAINTS

EMDs are required to document and respond to each complaint received concerning any product or service offered by the EMD. It is incumbent upon EMDs to have high standards for complaint handling in order to ensure that client complaints are dealt with in an efficient manner that is fair to all parties. This, in turn, fosters confidence in the integrity of the capital markets and its industry participants.

Complaints should be assessed to differentiate them into 2 categories:

- service complaints: of a less serious nature, related to service issues
- substantive complaints: related to trading or advising activity or matters of a serious nature

Substantive complaints include those complaints which involve:

- trading or advising activity
- a breach of client confidentiality
- theft, fraud, misappropriation, or forgery
- misrepresentation
- undisclosed or prohibited conflicts of interest
- personal financial dealings with a client
- other serious matters not listed above

The treatment of substantive complaints involving trading, advising, and other serious matters must be handled according to regulatory requirements. Complaint handling requirements for EMDs are established in NI 31-103, section 13.15.

ACKNOWLEDGEMENT

Where a substantive complaint is received, the EMD must promptly (generally within 5 business days) provide the client with a written acknowledgement of the complaint that includes the following:

- a description of the EMD's complaint handling obligations
- the steps that the client must take in order to access the dispute resolution services from the Ombudsman for Banking Services and Investments (OBSI)
- the name and contact information for OBSI

SUBSTANTIVE RESPONSE

Following investigation of the complaint, the EMD is required to provide a substantive response in writing which communicates the EMDs findings and its decision to either:

- make a settlement offer to resolve the complaint; or
- reject the complaint based on a finding of no merit.

The substantive response must be provided in writing and must include the following:

- a description of the EMD's complaint handling obligations
- the steps that the client must take in order to access the dispute resolution services of OBSI
- the name and contact information for OBSI

EMDs are generally expected to complete their investigation and provide their substantive response within 90 days from the receipt of the complaint. This time limit may be extended in appropriate circumstances, such as in cases where the client has not responded to information requests promptly or where complaints are sufficiently complex.

OMBUDSMAN FOR BANKING SERVICES AND INVESTMENTS (OBSI) DISPUTE RESOLUTION

The dispute resolution services from the Ombudsman for Banking Services and Investments (OBSI) must be made available if:

- After 90 days from receiving the complaint, the EMD has not provided a substantive response and the client notifies OBSI that they wish to have the complaint considered by OBSI
- Within 180 days of the client's receipt of the substantive response and the client notifies OBSI that they wish to have the complaint considered by OBSI

Clients can only access the dispute resolution services of OBSI where their claim is no greater than $350,000.00.

REGULATORY COMPLIANCE REVIEWS AND AUDITS

EMDs are subject to oversight by the provincial securities commissions and regulators which includes onsite reviews and audits of their operations. The securities regulators also conduct targeted reviews, referred to as "sweeps", which are conducted with respect to a specific topic or a specific industry sector.

EXAMPLE

The Manitoba Securities Commission initiates a compliance sweep on a sample of exempt market dealers to investigate whether the accredited investor exemption is being applied and relied on in the appropriate manner. They also decide to look at the processes for collecting and documenting client investment needs and objectives and risk profile.

In a compliance review or sweep of an EMD, the securities regulator will generally:

- interview the EMD's senior management and other key employees
- examine the EMD's books, records, and financial transactions
- assess the EMD's internal controls, compliance system, disclosure, marketing practices, and policies and procedures

During the course of a compliance review, the regulator may call clients directly and ask questions about the EMD and the Dealing Representatives. When the review is complete, where issues are identified, the regulator will issue a compliance audit report citing any deficiencies. The EMD is required to provide a written response to the regulator to address the deficiencies cited in the compliance audit report and implement corrective action where necessary. In cases where there are serious deficiencies, regulators may also take immediate action against an EMD such as imposing terms and conditions on the firm's registration, referring the matter to enforcement, or suspending the registration of the firm or its representatives.

OUTSOURCING

In some cases, an EMD may not have the necessary infrastructure and/or systems internally in order to support all of the functions of the compliance regime. In such cases, the EMD may choose to outsource some of their compliance functions to an outside service provider. For example, many EMDs outsource their books and records to systems providers who specialize in providing systems/software for dealer books and records.

COMPLIANCE CANNOT BE DELEGATED

It is important to note that while an EMD may outsource certain functions and tasks to a service provider, they cannot delegate their responsibility for compliance. Under legislation and regulations, the EMD remains responsible and accountable for all functions that they outsource to a service provider.

EXAMPLE

Jones & Smith Co. is an exempt market dealer registered in Ontario and they do not have the internal capacity to generate their client account statements. They decide to outsource the client account statements to KKV Solutions Inc. When KKV Solutions produces the client account statements, they do not include the total market value of each security position in the account as required under NI 31-103, section 14.14(5). When Jones & Smith Co. is examined by the Ontario Securities Commission (OSC), they are found deficient because their statements do not comply with requirements. The OSC gives Jones & Smith Co. 60 days to correct their client account statements.

ACCESS

The EMD, the EMD's auditor, and the EMD's regulator must have the same access to the work product of a service provider as they would if the EMD itself performed the function. Provisions covering this access should be encompassed into the contract between the EMD and the service provider.

DUE DILIGENCE AND CONTRACT

Since EMDs are ultimately responsible and accountable for any functions they outsource to a service provider, they should conduct due diligence on any prospective service providers. Due diligence should include an assessment of the service provider's:

- reputation
- financial stability
- internal controls
- ability to deliver the services

There should be a written, legally binding contract with the service provider that includes the expectations of the parties to ensure that the EMD gets what it needs to monitor the provider's ongoing compliance. The EMD is ultimately responsible and they are therefore expected to monitor the service provider. EMDs should monitor service providers on an ongoing basis to ensure that they deliver high quality, compliant products and services.

Quality	Conduct ongoing reviews to assess the quality of products and services provided
Privacy	Ensure that adequate safeguards are in place for keeping information confidential and to ensure that privacy laws are observed
Continuity	Ensure that disaster recovery capabilities are in place and develop and test a business continuity plan in conjunction with the service provider

Compliance with Other Legislation and Regulations

3

CONTENT AREAS

Other Legislation and Regulations

INTRODUCTION

This lesson covers compliance with other legislation and regulations.

This lesson takes approximately 20 minutes to complete.

LEARNING OBJECTIVES

At the end of this lesson, you will be able to:

1 | Discuss anti-money laundering and terrorist financing requirements.

2 | Discuss privacy requirements.

3 | Discuss the National Do Not Call List (DNCL).

4 | Discuss Canadian Anti-Spam legislation.

5 | Discuss the US Foreign Account Tax Compliance Act (FATCA).

OTHER LEGISLATION AND REGULATIONS

In addition to securities legislation and regulations, securities industry participants are subject to other applicable legislation in Canada including those concerning:

- money laundering and terrorist financing
- privacy
- telemarketing
- anti-spam legislation
- US foreign tax requirements

PROCEEDS OF CRIME (MONEY LAUNDERING) AND TERRORIST FINANCING

Securities industry participants are subject to federal legislation governing money laundering and terrorist financing requirements, which are enacted in the Proceeds of Crime (Money Laundering) and Terrorist Financing Act (PCMLTFA).[1]

The objectives of the PCMLTFA are to:

- implement measures to detect and deter money laundering and terrorist financing
- facilitate the investigation or prosecution of money laundering and terrorist financing offences

The Financial Transactions and Reports Analysis Centre of Canada (FINTRAC) is charged with the responsibility of enforcing the requirements in the PCMLTF Act and Regulations. Securities industry participants, including EMDs and Dealing Representatives, must comply with the FINTRAC Guidelines.

[1] Revised requirements under the Proceeds of Crime (Money Laundering) and Terrorist Financing legislation, regulations, and FINTRAC Guidelines came into force June 2020. The new requirements will be reflected in the next version of the course. For exam purposes, the content in this version of the course will apply.

Under anti-money laundering/terrorist financing (AMLTF) requirements, EMDs are required to:

- establish an effective compliance regime
- appoint a Compliance Officer who is responsible for:
  - implementing and maintaining the AMLTF compliance regime
  - reporting on a regular basis to the Board of Directors on the status of AMLTF compliance
- establish and maintain written policies and procedures
- conduct surveillance with the objective of detecting improper activities including:
  - establishing the identity of clients when new accounts are opened
  - large transaction reviews
  - suspicious transaction reviews
  - terrorist property reviews
- file surveillance reports including:
  - Suspicious Transaction Reports
  - Large Cash Transaction Reports
  - Terrorist Property Reports
  - Monthly Suppression of Terrorism and UN Sanctions Reports

SUSPICIOUS TRANSACTION REPORTS

You, as a Dealing Representative, are the person with the face-to-face, front-line relationship with clients. Therefore, you are in the best position to identify persons and transactions that are suspicious in terms of money laundering and terrorist financing. As such, the onus for identifying suspicious transactions falls largely on you.

AMLTF legislation defines a suspicious transaction as a "financial transaction that occurs in the course of (business) activities and in respect of which there are reasonable grounds to suspect the transaction is related to the commission of a money laundering offence and/or a terrorist activity financing offence".

Even if only an attempt is made and the transaction is not completed, it must still be reported. As a general guideline, a transaction may be connected to money laundering or terrorist activity when it or a group of transactions gives rise to discomfort, apprehension, or mistrust.

In assessing whether a transaction is suspicious, all the relevant factors should be considered including knowledge of the client's business, their financial history, background, and typical behavior. Sections 7 and 8 of FINTRAC Guideline 2 provide some examples of common indicators that transactions could be suspicious. You must be aware of the indicators that render a client or a transaction suspicious. Some common indicators are listed in the table below.

Common Indicators of Suspicious Transactions	
1.	Normal attempts to verify the background and identity of a client are difficult or the client uses aliases
2.	The client attempts to purchase investments with cash
3.	Clients who wish to purchase investments with money orders, traveler's cheques, cashier's cheques, bank drafts, foreign bank drafts, or other bank instruments

Common Indicators of Suspicious Transactions	
4.	Clients located outside of Canada: • Offshore accounts • Transactions to be funded by international wire payments • Transfers to overseas accounts Transactions involving any countries deemed as requiring enhanced surveillance by the Financial Action Task Force (http://www.fatf-gafi.org)
5.	Third Party Transactions: • Identity of the beneficiary or counterparty is undisclosed • Client attempts to purchase investments with instruments in the name of a third party • Payments made by way of third party cheques payable to, or endorsed over to, the client • Multiple deposits made to a client's account by third parties
6.	Transactions of a very large dollar amount
7.	Transactions that seem inconsistent/do not make sense: • Inconsistent with the client's apparent financial standing • Not economically viable for the client • Client is willing to deposit or invest at rates that are not advantageous or competitive • frequent withdrawals and deposits
8.	Transactions that appear to be unnecessarily complex
9.	Clients who seem very conversant on money laundering requirements or attempts to perform transactions that would purposefully avert detection (e.g. two or more cash transactions of less than $10,000 each just outside of 24 hours apart)
10.	You are aware or you become aware, from a reliable source (including media or other open sources), that a client is suspected of being involved in illegal activity

The above list of common indicators is not conclusive. Sections 7 and 8 of FINTRAC Guideline 2 lists over 150 indicators that persons or transactions could be suspicious and you are well advised to familiarize yourself with FINTRAC's indicators at http://www.fintrac-canafe.gc.ca/publications/guide/Guide2/2-eng.asp.

EMDs must submit a Suspicious Transaction Report to FINTRAC within 30 days. Therefore, if you identify a suspicious or attempted suspicious transaction, it is critical that you report it to the AMLTF Compliance Officer immediately and you must do nothing to "tip" the client that you have such a suspicion or are making a report.

LARGE CASH TRANSACTION REPORTS

EMDs must submit a Large Transaction Report to FINTRAC for:

- any cash transaction of $10,000 or more
- a combination of cash transactions of less than $10,000 that are made within a 24 hour period which cumulatively amount to more than $10,000

It is effectively a universal practice in the financial services industry not to accept any amount of cash for investment. Should an exception ever be made, with the prior approval of your AMLTF Compliance Officer, the transaction must be reported to FINTRAC.

TERRORIST PROPERTY REPORTS

EMDs must submit a Terrorist Property Report to FINTRAC if:

- it has property in its possession or control that it **knows** is owned or controlled by or on behalf of a terrorist or a terrorist group
- it has property in its possession or control that it **believes** is owned or controlled by or on behalf of a listed person[2]

MONTHLY SUPPRESSION OF TERRORISM AND UN SANCTIONS REPORT

EMDs must submit a monthly suppression of terrorism and UN Sanctions Report with its principal securities regulator. Each provincial and territorial regulator has this form on its website.

PENALTIES

The penalties for failing to report suspicious transactions, large cash transactions, or failing to satisfy AMLTF record keeping requirements can be severe.

Penalties Anti-Money Laundering and Terrorist Financing	
Transgression/Offence	**Penalty**
Failure to report suspicious transactions	Up to $2 million and/or 5 years imprisonment
Failure to report a Large Cash Transaction or an Electronic Funds Transfer	Up to $500,000 for the first offence, $1 million for subsequent offences
Failure to meet record keeping requirements	Up to $500,000 and/or 5 years imprisonment
Failure to provide assistance or provide information during a compliance examination	Up to $500,000 and/or 5 years imprisonment
Disclosing the fact that a suspicious transaction report was made, or disclosing the contents of such a report, with the intent to prejudice a criminal investigation	Up to 2 years imprisonment

PRIVACY LEGISLATION

EMDs are subject to federal and provincial legislation governing privacy and the use of personal information. Privacy legislation establishes rules that govern the way in which governments and private sector organizations may collect, use, or disclose personal information, including the giving of knowledgeable consent by individuals to the collection, use, and disclosure of their personal information. Privacy legislation in Canada also gives individuals the right to access the personal information that governments and private sector organizations may have collected about them and to request the correction of errors and omissions in that information.

[2] A listed person is an individual or entity published in the Regulations issued under the United Nations Act. The list is available on the website for the Office of Superintendent of Financial Institutions (OSFI).

Privacy laws require EMDs to:

- designate an individual or individuals who are accountable for the organization's compliance with privacy legislation, regulations, and principles
- have a written privacy policy which is available to the public
- have a mechanism for individuals to request access to the personal information held by the firm
- have a means to obtain consent from individuals for the use of the information
- disclose the purposes for which information is obtained
- limit collection to only that which is required to fulfil the declared purposes
- limit use, disclosure, and retention of the information
- safeguard the information
- have appropriate processes for disposal of information when it is no longer required
- have a system for individuals to lodge a complaint about any alleged violation of their privacy rights by the firm

Privacy is a fundamental right under Canadian law. You, as a Dealing Representative, have access to private and confidential information concerning your clients and it is your responsibility to safeguard that information. Therefore, your day-to-day practices must include measures to protect client data such as encrypting electronic information, locking files away after use, password protecting mobile devices, and strictly adhering to the policies of your EMD. The privacy commissioners, both federal and provincial, have the authority to investigate complaints against organizations, conduct audits of organizations suspected of not complying with privacy laws, report publicly on how organizations handle personal information, and to pursue court action.

NATIONAL DO NOT CALL LIST

The National Do Not Call List (DNCL) is administered by the Canadian Radio-Television and Telecommunications Commission (CRTC). When an individual signs up to have their home phone, mobile, or fax number included on the list, telemarketers are not allowed to make unsolicited marketing or sales calls to the number. The CRTC has the authority to levy penalties on offenders.

Under the National DNCL, the onus is on the individual to opt out of receiving unwanted calls by including his or her phone number on the list. Organizations, such as those in the financial sector, are restricted from calling those listed on the DNCL. All companies and organizations are also required to maintain their own DNCL and individuals can ask to be put on the DNCL.

Participants in the financial sector, including exempt market dealers, are free to call numbers for marketing or sales purposes as long as they are not on the DNCL. It is, of course, also permissible to call existing clients while providing existing services, even if they are on the DNCL. Businesses are also allowed to continue calling clients up to 18 months after a client has ceased to do business with them. However, unsolicited calls to offer new services or products are not permitted if they are on the DNCL.

CANADIAN ANTI-SPAM LEGISLATION (CASL)

Canadian Anti-Spam Legislation (CASL) is one of the most stringent initiatives globally designed to severely restrict the delivery of unsolicited commercial electronic messages (CEMs).

The definition of a CEM is very broad:

> *"A commercial electronic message is an electronic message that, having regard to the content, the hyperlinks in the message to content on a website or other database, or the contact information contained in the message, it would be reasonable to conclude its purposes is to encourage participation in a commercial activity…"*

CEMs are essentially emails that can be construed as having a commercial purpose. Malware, spyware, pretexting, and the harvesting of electronic addresses and personal information are also regulated under CASL.

Under CASL, all businesses must obtain the consent of recipients of CEMs before sending them. There are exceptions to the requirements, the most significant being that "consent" is implied for 36 months beginning July 1, 2014, where there is an existing business or non-business relationship that includes communication by CEMs. However, implied consent will end if the recipient indicates that they no longer want to receive CEMs.

Under CASL, all CEMs must contain the following information:

- the firm's full business name and mailing address
- the name of the person sending the message or the person on whose behalf it is being sent
- a current email address or website address
- an offer to the recipient to unsubscribe from CEMs

EMDs must maintain evidence of having received consent in order to send CEMs to their clients. Firms must have a process for tracking:

- recipients who have consented
- recipients who have not consented
- recipients who have withdrawn their consent

Under CASL, recipients who "unsubscribe" should be removed from the sender's mailing list within 10 days.

WHAT YOU CANNOT DO

You cannot send or cause or permit to be sent to an electronic address a commercial electronic message unless the:

- recipient has consented to receiving it
- message complies with prescribed form and content requirements (including the offer to unsubscribe)

PENALTIES

Violators can be liable for monetary penalties of up to $10 million per organization and up to $1 million per individual.

THE FOREIGN ACCOUNT TAX COMPLIANCE ACT (FATCA)

The government of the United States (US) has long been concerned that certain US taxpayers were evading the payment of taxes by investing offshore. The US Foreign Account Tax Compliance Act (FATCA) targets those taxpayers.

FATCA requires foreign financial institutions, including firms in the Canadian financial sector, to report about:

- financial accounts held by US taxpayers
- foreign entities in which US taxpayers hold a substantial ownership interest

If a Canadian financial institution does not comply with FATCA, it faces a 30% withholding tax on certain US-source payments made to it. This is extremely punitive and constitutes a powerful incentive to comply.

In order to facilitate compliance with FATCA, the Canadian and US governments have entered into an Inter-Governmental Agreement (IGA) which has been incorporated into Part XVIII of the Income Tax Act of Canada (ITA).

Under Part XVIII of the ITA, Canadian financial institutions, including mutual fund dealers, must:

- identify accounts held by clients who are a US person for US tax purposes
- report to the Canada Revenue Agency (CRA) specified information about the accounts identified as being held by US persons

IDENTIFYING US PERSONS

In general, a person is a US person for US tax purposes if that person is a US resident or a US citizen. However, a person that has economic and social ties that are closer to Canada than the US would not generally be considered to be a US resident.

EXISTING CLIENTS

In order to identify existing clients under FATCA, Canadian financial institutions must review information already in its possession for indications that the client may be a US person, for example a US address. If there is such an indication, the Canadian financial institution must ask the client to certify whether they are a US person. The client may be asked to provide supporting documentation if they claim not to be a US person.

NEW CLIENTS

In order to identify new clients under FATCA, Canadian financial institutions must ask clients to certify whether they are a US person at the time that the account is opened. The firm must then confirm the reasonableness of the client's certification based on the other information provided by the client when opening the account. Alternatively, the firm may follow a process similar to that described above for existing clients, based on the information provided by the client when the account is opened.

FAILURE TO COOPERATE

If a Canadian financial institution has information in its records that shows that a client may be a US person, and the client refuses to cooperate in clarifying his or her status, the firm must report the account as a US account to the Canada Revenue Agency (CRA). CRA will report information about the account to the US Internal Revenue Service (IRS).

ACCOUNTS IDENTIFIED AS US PERSONS

For accounts identified as being held by US persons, Canadian financial institutions (including mutual fund dealers) must report the following information to CRA:

- information about the account holder (e.g. name, address, the individual's US taxpayer identification number)
- certain financial information pertaining to the account

CRA, in turn, will automatically report the information to the IRS.

By complying with Part XVIII of the ITA, Canadian financial institutions avoid being exposed to the punitive 30% withholding tax under FATCA.

As a Dealing Representative, you should familiarize yourself with your dealer's policies and procedures regarding FATCA. You may have responsibilities for identifying clients who are US persons, particularly at the time of account opening.

UNIT SUMMARY

Congratulations, you have reached the end of Unit 3: Compliance for Exempt Market Dealers.

In this unit you covered:

- Lesson 1: The Compliance Regime
- Lesson 2: Compliance Duties of Exempt Market Dealers
- Lesson 3: Compliance with Other Legislation and Regulations

Now that you have completed these lessons, you are ready to assess your knowledge with a 10-question quiz. To start the quiz, return to the IFSE Landing Page and click on the Unit 3 Quiz button.

UNIT 4

DEALING WITH CLIENTS

INTRODUCTION

In this unit you will learn about your responsibilities and duties when dealing with clients.

This unit takes approximately 1 hour to complete.

Lessons in this unit:

1. Standard of Conduct
2. Establishing the Relationship with the Client
3. Conflicts of Interest
4. New Accounts
5. Client Assets
6. Registered Plans

Standard of Conduct 1

CONTENT AREAS

INTRODUCTION

In this lesson you will learn about your Standard of Conduct obligations as a Dealing Representative.

This lesson takes approximately 5 minutes to complete.

At the end of this lesson, you will be able to:

LEARNING OBJECTIVES

At the end of this lesson, you will be able to:

1 | Define and describe your regulatory obligations concerning Standard of Conduct.

2 | Provide examples of practices which observe high standards of conduct.

STANDARD OF CONDUCT

Participants in the investment industry are expected to observe high standards of ethics and conduct in their dealings with the investing public. Most important are the ethical principles of trust, integrity, fairness, and honesty. These standards and principles are instilled into the rules and regulations of every level of regulatory authority at the securities commissions and regulators, the self-regulatory organizations (SROs), and the Canadian Securities Administrators (CSA).

Ontario Securities Commission (OSC) Rule 31-505, Section 2.1 states:

"**2.1 General Duties**

(1) A registered dealer or adviser shall deal fairly, honestly and in good faith with its clients.

(2) A representative of a registered dealer or registered adviser shall deal fairly, honestly and in good faith with his or her clients."

Similar rules to "deal fairly, honestly and in good faith with clients" have been enacted into the rules and regulations of all of the securities regulators in Canada.

In Companion Policy (CP) 31-103, Part 1.1 (Clear and Meaningful Disclosure to Clients), it states:

> *"We expect registrants to present disclosure information to clients in a clear and meaningful manner in order to ensure clients understand the information presented. Registrants should ensure that investors can readily understand the information. These requirements are consistent with the obligation to deal fairly, honestly and in good faith with clients."*

Further, CP 31-103, Part 1.3 (Fitness for Registration (b) Integrity) states:

> *"Registered individuals must conduct themselves with integrity and have an honest character."*

The securities regulators also define the expectations of registered firms, including EMDs, to ensure that their registrants and Dealing Representatives observe high standards of conduct. In CP 31-103, Part 11.1 (Compliance System (a) Day-to-Day Monitoring) it states:

"Anyone who supervises registered individuals has a responsibility on behalf of the firm to take all reasonable measures to ensure that each of these individuals:

- deals fairly, honestly and in good faith with their clients
- addresses conflicts of interest in the best interest of their clients
- puts the client's interests first when making suitability determinations for their clients

- complies with securities legislation
- complies with the firm's policies and procedures, and
- maintains an appropriate level of proficiency."

It is a fundamental principle that you, as a Dealing Representative, deal fairly, honestly, and in good faith with your clients. Far from being strictly a regulatory requirement, this standard of conduct makes good business sense. Even in the absence of a regulatory requirement, Dealing Representatives should exercise a high standard of conduct in order to:

- protect their reputation and that of the industry
- attract and retain clients
- be successful in the long term

Below are some examples of practices which observe high standards of conduct:

- fully understanding the financial circumstances of clients
- presenting all investment recommendations fairly and without false or misleading statements
- always making recommendations in the best interests of the client
- clearly distinguishing fact from opinion when making recommendations
- protecting the confidentiality of client information
- maintaining proficiency and staying informed about new investment products, financial markets, laws, and regulations

Many of these practices have been codified into the specific rules and regulations of the securities regulators.

TRADE NAMES AND BUSINESS TITLES

National Instrument (NI) 31-103, s. 13.18 establishes the requirements governing trade names and business titles. Any trade name or business title that you use cannot be misleading and you must observe the "holding out rule" at all times. This rule prohibits you from "holding yourself out" to the public in any manner which could reasonably be expected to deceive or mislead a client or other person about your:

- proficiency
- experience
- qualifications
- registration category
- nature of your relationship with the firm/individual
- products and/or services to be provided

The rules establish that you are restricted from using any titles or designations which are:

- based partly or entirely on your sales activity or revenue generation
- a corporate officer title (e.g. Vice President, Director), unless you have been appointed to the office under applicable corporate law
- not approved by the firm

You should be fully versed in your firm's policies and procedures for business titles and learn which business titles and designations you may use, how they may be used, and those business titles and designations which would be restricted or prohibited.

EXAMPLE: HOLDING OUT RULE

Christopher Smith works as a Dealing Representative with ABC Investments Inc. Christopher is also a Chartered Professional Accountant (CPA). Christopher has business cards printed with the following information:

ABC Investments Inc.

Christopher Smith

Chartered Professional Accountant

543 Finance Street, Suite #100
Capital City, Alberta, A1B 2C3
403-555-1212
csmith@abcinvest.ca

In the example above, Christopher is holding out a legitimate designation to the public in a misleading manner. Although he is qualified as a Chartered Professional Accountant, he is not employed by ABC Investments in that capacity. Instead, Christopher is permitted to add the "CPA" designation after his name, like this:

ABC Investments Inc.

Christopher Smith, CPA

Dealing Representative

543 Finance Street, Suite #100
Capital City, Alberta, A1B 2C3
403-555-1212
csmith@abcinvest.ca

It is important to note that the regulators assign a great deal of importance to the use of business titles which convey expertise in seniors' issues or retirement planning. You must be fully qualified in order to use any such designations. Acceptable designations would be those that:

- have a rigorous curriculum and examination process
- have experience requirements
- are issued by reputable organizations

Business cards and other stationary items, such as letterhead or fax cover sheets, are all subject to the rules for business titles and trade names. As such, all stationary materials must be pre-approved by your EMD in the same way as sales communications and advertisements.

Establishing the Relationship with the Client

2

CONTENT AREAS

INTRODUCTION

In this lesson you will learn about your responsibilities and duties when establishing the relationship with the client.

This lesson takes approximately 5 minutes to complete.

LEARNING OBJECTIVES

At the end of this lesson, you will be able to:

1 | Explain the process of establishing the relationship with the client.

2 | Explain the Relationship Disclosure Information (RDI).

ESTABLISHING THE RELATIONSHIP

Client relationships are built on a strong foundation of transparency and clarity. Best practices include:

- establishing the relationship
- setting expectations
- providing disclosure and transparency

When a new account is opened for a client, the EMD is required to provide written disclosure of the Relationship Disclosure Information (RDI). As a Dealing Representative, you are expected to provide the RDI to your clients, discuss the RDI information with them, and be prepared to answer any questions.

The objective of the relationship disclosure requirement is to ensure that clients:

- understand their obligations and those of the exempt market dealer
- know what to expect with respect to products, service levels, and costs

The RDI will include, at minimum, the following elements:

Relationship Disclosure Information	
Account Type & Client Assets	• describes the nature/type of account • includes an explanation of how and where the client's assets are held ◦ e.g. in client name at the issuer

Firm & Advisory Relationship	• must discuss:
	  ◦ the firm is acting as an exempt market dealer (EMD)
	  ◦ how the EMD operates client accounts
	• describes the nature of the advisory relationship
	• establishes responsibility for investment advice and investment decisions

Relationship Disclosure Information	
Products & Services	• describes the products and services provided by the exempt market dealer • provides specific disclosure about: ◦ liquidity and resale restrictions ◦ investment fund management expense fees and ongoing fees ◦ other ongoing fees and expenses ◦ proprietary products ◦ securities of a related issuer • describes exempt products and explains: ◦ that exempt products are not offered by prospectus ◦ what that implies (specifics)
Cash & Cheques	• describes how the exempt market dealer receives and handles deposits and cheques from clients • establishes who the payee is for deposits and cheques
Risks	• describes the risks that a client should consider when: ◦ making investment decisions ◦ borrowing to invest ◦ investing in the exempt market
Conflicts of Interest	• describes the conflicts of interest that the exempt market dealer is required to disclose to the client
Suitability	• describes the exempt market dealer's suitability obligation including: ◦ the events that will trigger a suitability determination ◦ the obligation to put the client's interest first when determining suitability
Know Your Client (KYC)	• defines the terms for the KYC information collected • describes how the KYC information will be used in relation to specific investments that may be recommended or accepted for the client's account • describes how the KYC information will be used when assessing suitability
Client Reporting	• describes the frequency and content of reporting that will be sent to the client for: ◦ Trade Confirmations ◦ Client Account Statements ◦ Report on Charges and Other Compensation ◦ Performance Report

Relationship Disclosure Information	
Compensation and Benefits	• describes the nature of compensation that the exempt market dealer may receive, for example: ◦ commissions at the time of purchase ◦ trailer fees on an ongoing basis • refers to other sources for more specific information on compensation • describes the benefits to the exempt market dealer and/or Dealing Representative from other parties in connection with the client's investment with the dealer
Transaction Charges	• describes the types of transaction charges that the client may be required to pay
Impact on Returns	• explains the impact on a client's investment returns from: ◦ expenses and ongoing fees (described under Products and Services) ◦ charges (described under Transaction Charges) • includes the effect of compounding over time
Benchmarks	• explains how investment performance benchmarks might be used to assess the performance of the client's investments • provides investment performance benchmarks available from the exempt market dealer
Complaint Obligations	• describes the exempt market dealer's obligations with respect to complaints and the process for pursuing recourse with the Ombudsman for Banking Services and Investments (OBSI)

When you open a new account for a client, you are required to provide and explain the Relationship Disclosure Information (RDI). You are responsible for helping the client understand the nature of the relationship between you, your firm, and the client.

Under the RDI requirements, you are expected to:

- spend sufficient time with your clients to explain the RDI information
- discuss the RDI information with your clients in an in-person or telephone meeting
- be prepared to answer any questions
- follow their firm's policies and procedures to evidence that you have done so

You are expected to go through the RDI with your client at the beginning of your relationship to ensure that the client understands the information in the RDI. It may also be a good practice to re-visit the RDI with the client in subsequent meetings (e.g. in regular meetings or in subsequent meetings to discuss new investment products).

SETTING EXPECTATIONS

As part of the relationship discussion, you should discuss expectations and encourage the client to actively participate in the relationship. You should encourage clients to:

- **Keep you and the EMD up to date about their Know Your Client (KYC) information**. Clients should be encouraged to promptly notify you or the EMD about any change to their information that could result in a change to the types of investments appropriate for them, such as a change to their personal circumstances, financial circumstances, investment needs and objectives, risk profile, or time horizon.

- **Be informed about their investments**. Clients should be encouraged to fully understand their investments by asking questions, consulting professionals, and carefully reviewing the literature provided to them.
- **Stay informed about their investments**. Clients should be encouraged to review all account documentation provided to them and to regularly review portfolio holdings and performance. Clients should also be encouraged to request information from the EMD if they have concerns about their accounts, transactions, their relationship with the EMD, or their relationship with you.

MAINTAINING EVIDENCE OF RELATIONSHIP DISCLOSURE

You are required to maintain evidence that the RDI has been provided to your clients. If the relationship disclosure is incorporated into the New Client Application Form (NCAF) or account documentation and it is signed by the client, a copy of the relevant document in the client file is sufficient evidence.

If the relationship disclosure is provided as a stand-alone document, evidence of delivery may include:

- a signed client acknowledgement
- a copy of the RDI in the client file accompanied by detailed notes about the client meeting including that the RDI was provided

DISCLOSURE AND TRANSPARENCY

All disclosures provided to a client must be:

- **Accurate –** the disclosure must be accurate and up-to-date
- **Complete –** the disclosure must contain all material information and must not have any omissions of material information
- **Clear and understandable –** the disclosure provided to a client must be clear and understandable (e.g. plain language)
- **Relevant and useful to the client –** the disclosure must be relevant to the client's specific circumstances (e.g. relevant to the client's type of account)
- **Timely –** the timing of the disclosure must permit the client to act upon the information where necessary. Specifically, disclosure of conflicts of interest in respect of a particular transaction should be provided to the client before the transaction so the client can decide whether to proceed with the transaction.

Conflicts of Interest

3

CONTENT AREAS

INTRODUCTION

In this lesson you will learn about conflicts of interest and your responsibilities to identify and address those conflicts.

This lesson takes approximately 35 minutes to complete.

LEARNING OBJECTIVES

At the end of this lesson, you will be able to:

1 | Provide an overview of conflicts of interest.

2 | Define conflict of interest.

3 | Explain the criteria to be considered when determining whether a conflict is material.

4 | Discuss how conflicts of interest must be identified.

5 | Discuss how conflicts of interest must be addressed.

6 | Provide an overview of common conflicts of interest.

7 | Discuss dual occupations and outside activities.

8 | Discuss personal financial dealings and control or authority over client accounts.

9 | Discuss referral arrangements.

OVERVIEW

All registrants in the Canadian capital markets have a duty to identify and address conflicts of interest. The obligations concerning conflicts of interest permeate throughout all levels of securities legislation and regulations including:

- National Instrument (NI) 31-103, s. 13.4, 13.4.1, *Identifying, Addressing, and Disclosing Material Conflicts of Interest*
- Companion Policy (CP) 31-103, s. 13.4, 13.4.1, *Identifying, Addressing, and Disclosing Material Conflicts of Interest*

The overriding theme in the regulatory requirements is the obligation for registrants to address conflicts of interest in the best interest of the client.

Compliance with the conflict of interest requirements is an ongoing registrant obligation, not a one-time determination. You and your exempt market dealer (EMD) are required to take reasonable steps to identify both existing conflicts of interest and those conflicts of interest that are reasonably foreseeable.

DEFINITION OF CONFLICT

In general, a conflict of interest is a situation where there is a divergence between the interests of two or more parties.

Under Companion Policy (CP) 31-103, Part 13, Division 2, s. 13.4.1, the Canadian Securities Administrators (CSA) specifically define a conflict of interest to include any circumstance where:

- the interests of a client and those of a registrant are inconsistent or divergent
- a registrant may be influenced to put their interests ahead of their client's interests
- the trust that a reasonable client has in their registrant may be compromised as a result of:
  - monetary or non-monetary benefits available to the registrant
  - potential detriments that the registrant may be subject to

As specified in the policy, you and your EMD are required to determine whether a conflict is material. When determining whether a conflict is material, you should consider whether the conflict may be reasonably expected to affect:

- the decisions of the client
- the recommendations or decisions you make

CONFLICTS OF INTEREST BETWEEN REGISTRANTS AND CLIENTS

The requirements governing conflicts of interest between registrants and clients have been developed under the *Client Focused Reforms* (CFR) and brought into force under NI 31-103. Under the reforms, you must take reasonable steps to:

- identify existing and reasonably foreseeable material conflicts of interest
- address all material conflicts of interest in the best interest of the client

You, as a Dealing Representative, have specific responsibilities under the CFR requirements, as summarized below.

Your Responsibilities for Conflicts of Interest
You are responsible for: • taking reasonable steps to identify existing and reasonably foreseeable material conflicts of interest • promptly reporting material conflicts of interest to your EMD • addressing material conflicts of interest in the best interest of the client • avoiding all material conflicts of interest where the conflict cannot be addressed in the best interest of the client You are prohibited from engaging in trading and/or advising activities unless: • the conflict has been addressed in the best interest of the client; and • your EMD has approved the activity

You must position your practice to minimize, recognize, and address conflicts and keep records of any conflicts that have arisen and how they were resolved.

Your EMD also has specific responsibilities under the CFR requirements, as summarized below.

Responsibilities of the EMD

Registered firms, including EMDs, are responsible for:

- taking reasonable steps to identify existing and reasonably foreseeable material conflicts of interest between:
  - the firm and the client
  - each individual acting on the firm's behalf and the client
- addressing material conflicts of interest in the best interests of the client(s)
- avoiding all material conflicts of interest where the conflicts cannot be addressed in the best interests of the client(s)
- disclosing material conflicts of interest to clients in writing

IDENTIFYING CONFLICTS OF INTEREST

Conflicts of interest will arise in the ordinary course of business. Some conflicts are inherent to the firm's business model. Other conflicts may arise from the business activities you carry out.

Conflicts of interest may take various forms such as:

- existing - involving an actual conflict as a result of current activities
- potential - involving likely future conflicts
- perceived - involving circumstances creating the appearance of a conflict

Figure 4.1

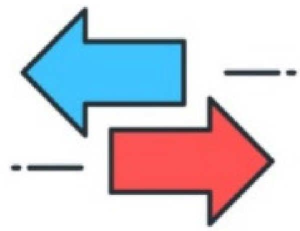
By their very nature, conflicts can interfere with your ability to deal fairly, honestly, and in good faith with clients. It is simply good business to know how conflicts arise and understand the duty to identify and address them.

You are required to take reasonable steps to identify existing and reasonably foreseeable material conflicts of interest.

As established in CP 31-103, reasonable steps to identify material conflicts of interest would include:

- taking proactive measures to anticipate reasonably foreseeable conflicts
- implementing policies and procedures to identify existing conflicts
- assessing the materiality of those conflicts to distinguish between those conflicts that are material and those that are not

Figure 4.2



The duty to identify and address conflicts of interest is not viewed as a one-time exercise and compliance with the conflict of interest requirements is an ongoing obligation. Therefore, you are expected to assess and address new conflicts as they are identified.

ADDRESSING CONFLICTS OF INTEREST

A conflict of interest can be addressed in one of three ways:

- avoidance
- control
- disclosure

Where a conflict of interest between you and your client is identified, you are subject to specific regulatory obligations where the conflict is deemed to be material. You must:

- address all material conflicts of interest in the best interest of the client
- avoid all material conflicts of interest where the conflict cannot be addressed in the best interest of the client

When addressing a ***material*** conflict of interest, you and your EMD are required to either:

- implement controls to mitigate the conflict sufficiently so that the conflict is addressed in the client's best interest;

or

- avoid the conflict.

Your failure to identify and properly address a conflict could put you and your EMD at risk of disciplinary action by the regulators or civil action by a client. Therefore, it is important that you understand and commit to the notion that you must address all material conflicts of interest in the best interest of the client and avoid those material conflicts of interest that cannot be addressed in the best interest of the client.

AVOIDANCE

You are required to avoid all conflicts of interest that are prohibited by law. Examples of conflicts of interest that must be avoided include those practices prohibited under securities legislation and regulations, or other activity that is sufficiently contrary to the integrity of the capital market and/or the interests of investor(s).

Even where a conflict of interest is not legally prohibited, it must be avoided if there can be no other reasonable response. Under CP 31-103, Part 13, Division 2, s. 13.4.1, you would be expected to avoid material conflicts of interest:

- where there are no appropriate controls available that would address the conflict in the best interest of the client

- where avoiding the conflict is the only reasonable response in order to address the conflict in the best interest of the client
- even if avoiding the conflict means foregoing an otherwise attractive business opportunity or type of compensation

Where you determine that a material conflict of interest should be avoided, you may do so by:

- refusing to engage in the activity
- ceasing to provide the product or service
- declining to deal with the client

CONTROL

When determining how to address material conflicts of interest, your EMD must consider what internal structures or policies and procedures can be implemented in order to address the conflict of interest in the best interest of the client.

CONFLICTS ARISING FROM COMPENSATION AND INCENTIVES

It is important to note that the regulators assign a great deal of importance to conflicts arising from compensation and incentives. As such, you should focus specific attention to your EMD's policies and procedures governing conflicts that arise from compensation and incentives to ensure that:

- you adhere to the firm's requirements
- conflicts of interest are addressed in the best interests of clients

Conflicts arising from internal compensation arrangements and incentive practices

As stated in CP 31-103, s. 13.4.1:

"It is an inherent conflict of interest for registered firms to create incentives to sell or recommend certain products or services over others. It is also an inherent conflict of interest for registered individuals to receive greater compensation from their sponsoring firm for the sale or recommendation of certain products or services over others. In our experience these are almost always material conflicts of interest."

The CP goes on to state:

"In addition to controlling these conflicts in the best interest of clients, registrants must comply with the suitability determination obligation under section 13.3. If certain products or services available at a firm compensate its registered individuals better than others, in addition to determining that the recommendation is suitable, registered individuals must put their clients' interest first when deciding which product or service to recommend. As a result, the client's interests, not the registrant's interests, must guide the recommendations made by a registrant to its clients. Registrants must not recommend a product or service just because it pays them better than the alternatives. This is also consistent with a registrant's obligation to deal fairly, honestly and in good faith with its clients."

DISCLOSURE

The purpose of disclosing a conflict of interest is to provide the client with adequate information so that they can decide for themselves whether the conflict is serious enough to lead them to withdraw from the transaction or service. EMDs are required to provide written disclosure to clients to disclose all material conflicts of interest identified and reported to the firm. Where required, you may likely be responsible for providing disclosures prescribed by the firm.

Disclosure about conflicts of interest must be:

- prominent, specific, clear, and meaningful to the client, so that they can understand the conflict of interest and how it could affect the product or service that is being offered
- made prior to or at the time of the investment recommendation or service, so the client has time to assess the information

Written disclosure of material conflicts of interest must include:

- the nature and extent of the conflict
- the potential impact and risk the conflict may pose
- how the conflict has/will be addressed

Where a material conflict of interest is identified that has not been previously disclosed to the client, the EMD is responsible for providing disclosure to the client in a timely manner. In some cases, you will be required to provide disclosure to the client when these circumstances arise.

While disclosure can be effective in addressing certain conflicts of interest, disclosure alone is not considered sufficient to address a material conflict of interest between a registrant and a client. Disclosure is meant to supplement other measures and controls taken to address the conflicts.

EXAMPLE

Fadila is a Dealing Representative with InvestRite Inc., an exempt market dealer. Fadila's client, Harbinder, buys flow-through shares and needs help completing his tax return, which is complex for flow-through shares. Luckily, Fadila has an ownership interest in Pro-Tax Services Ltd., a tax preparation firm. Before Fadila can refer Harbinder to Pro-Tax Services she must:

- obtain approval from InvestRite Inc. for her outside activity, Pro-Tax Services Ltd.
- obtain approval from InvestRite Inc. for the written disclosure for Pro-Tax Services Ltd., which must clearly disclose Fadila's conflicts of interest (e.g. Fadila will profit from her interest in Pro-Tax when Harbinder uses the service)
- provide the written disclosure for Pro-Tax Services Ltd. to her client, Harbinder, *before* she refers him to Pro-Tax

DISCLOSURE OF COMPENSATION CONFLICTS

As set out in CP 31-103, s. 13.4.1, you are expected to disclose to your clients any commissions or other compensation that you will receive for a transaction, ***before*** the transaction is executed. The CP also explicitly states:

"If a representative's compensation differs depending on the products or services provided, then this is a material conflict that must be disclosed to clients. With respect to the nature and extent of the conflict, the registrant should disclose a summary of the compensation conflict in plain language. For example, if particular products pay a larger percentage-commission than other products available to the client, the extent of the compensation difference should be explained."

LIMITATIONS OF DISCLOSURE

In some cases, disclosure can play an effective part in addressing conflicts of interest. However, disclosure alone would not be considered sufficient to address a material conflict of interest. For example, compensation and transaction charges are disclosed in the Relationship Disclosure Information (RDI) that is provided to clients when they open an account and in the Pre-Trade disclosure before an order is executed. However, there is an added expectation that there is adequate supervision by the firm to ensure that the fees are competitive, reasonable, and appropriate for clients.

There are also circumstances where disclosure would be clearly insufficient to address a conflict of interest. In such cases, you would need to avoid the conflict of interest. For example, disclosure may not be used to justify an unsuitable recommendation.

EXAMPLE

As noted by the Hearing Panel in the 2020 decision of the Alberta Securities Commission in Re Rustulka[1]:

"[228] …we reiterate that a registrant's suitability obligation is not discharged just because a client has said that he or she knew of or accepted the risk of an investment, or because he or she has signed documents to that effect. We agree with the panel in *Lamoureux* that, "no amount of disclosure to the investor, or acknowledgement by the investor, can convert an unsuitable investment into a suitable investment" (at p. 28) or displace a registrant's obligation to conduct a proper suitability assessment (at p. 16).

In the decision, the Dealing Representative was found to have breached his KYC and suitability obligations.

Once a conflict of interest has been identified and addressed, you must document the reasonable basis for your determination that the conflict of interest has been addressed in the best interests of the client(s). As the materiality of a conflict increases, there should be greater detail in the records maintained to demonstrate compliance. For example, the regulators would expect to see more detailed records for material conflicts related to sales practices, compensation arrangements, incentive practices, referral arrangements, and the use of proprietary products and services.

COMMON CONFLICTS OF INTEREST

As is inherent with any compensation-based industry, it is not uncommon for conflicts of interest to arise through the normal course of business conducted by you and your EMD. The important thing to do is to properly identify and address conflicts of interests that arise. Summarized below are some of the common conflicts of interest that can be expected to emerge at an exempt market dealer.

Common Conflicts of Interest for EMDs*

Type/Activity	**Potential Conflicts of Interest can Arise From:**

Related/Connected Issuer	• the issuer and the EMD are related
	• conflicts stem from the benefits and financial gains to the related/connected issuer, EMD, and/or shareholders
	• the EMD cannot recommend a trade in a security issued by it or a related/connected issuer or other affiliate unless they:
	  ○ ensure that any conflicts of interest are addressed in the best interest of the client; and
	  ○ disclose the nature and extent of the relationship or connection between the EMD and the issuer/affiliate

[1] (220 ABASC 93)

Common Conflicts of Interest for EMDs*	
Type/Activity	**Potential Conflicts of Interest can Arise From:**
Competing Interests between the Issuer and Investors	• the EMD is retained by the issuer to raise funds and access capital in the market: ∘ acts for the seller ∘ looking for the highest price and the broadest exposure to the market • the EMD and Dealing Representative have a duty to act for the investor: ∘ required to seek the best price for the client ∘ obligated to only recommend products that are suitable for the client ∘ obligated to only recommend products to clients who qualify for exemption • the Dealing Representative and EMD must act only in the best interest of the client and only recommend products that are suitable to properly qualified investors
Compensation-Related Conflicts	• conflicts stem from the compensation structure of a given product which may motivate the sale of that product • the product offers a higher commission rate or an ongoing stream of income over time while other products offer lower or finite commission potential • the Dealing Representative and EMD must act only in the best interest of the client and only recommend suitable investments to the client, irrespective of the compensation
Overselling and Over-Concentration	• conflicts stem from the motivation to sell more exempt products to the same client in order to earn compensation • exempt products are considered to be high risk investments by the regulators and overweighting a client's portfolio in exempt securities creates over-concentration • overselling and over-concentration is not suitable and not compliant
Referral Arrangements	• conflicts stem from referral fees, trailer fees, split commissions, other fees (e.g. syndication fees), and other benefits • the EMD/Dealing Representative must ensure that any conflicts of interest are addressed in the best interest of the client; and • the referral arrangement must be disclosed in writing in prescribed form before referrals can be made

Common Conflicts of Interest for EMDs*	
Type/Activity	**Potential Conflicts of Interest can Arise From:**

Dual Occupations and Outside Activities	• conflicts stem from:
	  ○ compensation from the dual occupation/outside activity
	  ○ a position of influence gained from the dual occupation/outside activity that could impact the relationship with clients
	• the EMD/Dealing Representative must ensure that any conflicts of interest are addressed in the best interest of the client; and
	• proper disclosure is provided to clients to disclose the conflict(s) of interest before engaging in the dual occupation/outside activity

** This is not meant to be an exhaustive list of all conflicts of interest. Other conflicts of interest may arise that are not included on this list, but would be material and would require that the EMD and Dealing Representative address the conflict of interest in the best interest of the client.*

When making a determination of how the firm will address a conflict of interest, the steps that the EMD must take to address the conflict of interest will most often be established in the legislation, regulations, and guidance from the securities regulators. It is your responsibility to follow your EMD's policies and procedures, and any decisions the EMD makes, to address conflicts of interest.

DUAL OCCUPATIONS AND OUTSIDE ACTIVITIES

Dual occupations and outside activities are permitted under securities legislation and regulations where prescribed conditions are satisfied. Dual occupations are business activities that are not carried out on behalf of the firm and involve the payment of compensation. Generally speaking, dual occupations are those business activities that do not fall under your role with your EMD, for example: insurance, mortgage brokerage, real estate, tax preparation, etc.

Figure 4.3

Outside activities include dual occupations, and also include activities that are not dual occupations (with or without compensation), for example:

- acting as a board member
- acting a member of a charitable organization
- acting as a volunteer in the community

As can be reasonably expected, there is a potential for conflicts of interest to arise when you engage in outside activities. For example, conflicts of interest can result from:

- compensation from the activity
- the nature of your relationship with the outside entity and/or any members of the outside entity
- conflicting duties of your role with your EMD and your role with the outside entity
- possible knowledge of insider information
- conflicting demands on your time

The securities regulators recognize the potential for conflicts of interest which can stem from outside activities. As such, the securities regulators have prescribed requirements pertaining to outside activities in their legislation, policies, rules, and regulations.

You are required to disclose your outside activities to your EMD:

- upon registration application: *Form 33-109F4 Registration of Individuals and Review of Permitted Individuals*
- before you commence new outside activities during the term of your registration: *Form 33-109F5 Change of Registration Information*

Your EMD is responsible for:

- reviewing and approving outside activities disclosed to the firm
- ensuring that outside activities, and associated trade names where applicable, are reported to the securities regulators
- ensuring that outside activities, and any associated conflicts of interest, are properly addressed in the best interest of client(s) and are disclosed to clients
- having supervisory controls in place in order to detect undisclosed outside activities

PERSONAL FINANCIAL DEALINGS AND CONTROL OR AUTHORITY OVER CLIENT ACCOUNTS

Personal financial dealings with clients or having control or authority over a client account will often create a conflict of interest that can potentially impair your ability to fulfill your obligations to your clients. You must be aware of the restrictions and limitations imposed by the regulators and strictly follow your EMD's policies and procedures related to personal financial dealings with clients and control or authority over client accounts.

	Personal Financial Dealings with Clients & Control or Authority over Client Accounts
Complete or Partial Control or Authority over a Client Account	• acting under a Power of Attorney (POA), as trustee, as executor, or under any other similar authorization, or otherwise having full or partial control or authority over the client's account or financial affairs • would represent a material conflict of interest that should either be avoided or otherwise addressed in the client's best interest • you are required to disclose your control or authority over any account to your firm and follow your firm's policies and procedures
Lending to Clients	• lending to clients is not permitted
Borrowing from Clients	• borrowing from clients is not permitted

	Personal Financial Dealings with Clients & Control or Authority over Client Accounts
Purchasing Assets from a Client	• purchasing an asset from a client outside the normal course of business (e.g. real property or other assets of significant value) • would represent a material conflict of interest that should be avoided *(You must follow your firm's policies and procedures for exceptions, where the firm allows such exceptions)*
Private Investment Schemes	• private investment schemes include: ◦ investment clubs where you and clients invest together ◦ co-investment by you and your clients in pyramid-like schemes or other questionable investments • these arrangements are prohibited • securities-related business outside of the firm is a breach of regulations
Positions of Influence in the Community	• you occupy a leadership role in the community (e.g. pastor at a local church, nurse at a nursing home) • you must disclose you role to the firm • the regulator will usually impose terms and conditions on you to restrict you from dealing with clients related to your role (e.g. restrict you from dealing with members of the church, patients of the nursing home, etc.) • at minimum, the firm must implement procedures to protect clients from undue influence

EXAMPLE

Dubem is a Dealing Representative with Newcastle Capital Inc., an exempt market dealer. Dubem's client, Fola, is 73 years old and she has recently been widowed. Fola does not have any children and she has not established a will. Fola places a great deal of trust in Dubem and she would like to gift $75,000 to him so that he can invest in expanding his business. Fola also wants to consider appointing Dubem as the executor of her estate.

While Dubem is a trustworthy and conscientious advisor to Fola, Dubem must avoid accepting monetary gifts or loans from Fola. Dubem must also avoid accepting appointment as the executor of her estate. Dealing Representatives must avoid having any authority over the financial affairs of their clients including as power of attorney, trustee, or executor. Dealing Representatives are also prohibited from accepting monetary gifts or loans from their clients.

REFERRAL ARRANGEMENTS

Referral arrangements are arrangements where a Dealing Representative agrees to provide or receive a referral fee for the referral of a client. A referral fee is any form of benefit or compensation, direct or indirect, for the referral of a client and includes the splitting of a commission or fee from a transaction. Referral arrangements can involve securities-related business (between registrants) and non-securities-related business (involving non-registrants).

Conflicts of interest can be expected to arise from referral arrangements due to the financial interests that emerge from receiving referral fees, splitting commissions, and other forms of compensation and benefits. It is also critically important to ensure that clear disclosure about the roles and responsibilities of all parties are provided to clients.

The following provisions apply with respect to referral arrangements:

Referral Arrangements

- there must be a written referral agreement in place before any referrals take place
- the registered firm(s) must be a party to the referral agreement
- all referral fees must be recorded on the books and records of the registered firm(s)
- written disclosure of the referral, in prescribed form, must be provided to clients before accounts are opened or services are provided to clients
- the registered firm must satisfy itself that the person/company that is accepting the referrals has the appropriate qualifications and/or registration to provide the services before any referrals take place
- the "Know Your Product" obligations apply to referral arrangements and registered firms are required to conduct due diligence to determine whether referral arrangements should be approved by the firm

Even if you directly negotiate a referral arrangement with another party, your EMD must be a party to the referral agreement. This is because the EMD is obligated to supervise and monitor activities under referral arrangements. You are not permitted to enter into referral arrangements "outside" of your firm. Such practices constitute undisclosed outside activities which are not compliant and can result in disciplinary actions against you by your firm, the regulators, or both.

It is important to note that the regulators assign a great deal of importance to conflicts arising from referral arrangements.

Conflicts related to referral arrangements

As stated in CP 31-103, s. 13.4.1:

"Paid referral arrangements are inherent conflicts of interest which, in our experience, are almost always material conflicts of interest, and must be addressed in the best interest of the client. Before a registrant refers a client, in exchange for a referral fee, to another party, the registrant must determine that making the referral is in the client's best interest. In making that determination, we expect registrants to consider the benefits to the client of making the particular referral over alternatives or at all.

In making a referral, registered firms and individuals must be guided only by the client's interests. We therefore expect that a registrant will not make a client referral to a party solely because of the referral fee that they will receive from that party, or because the amount or duration of the referral fee that they will receive from that party may be greater than the amount or duration of the referral fee that they would receive from a competitor to that party. If a client pays more for the same, or substantially similar, products or services as a result of a referral arrangement, we would not consider the inherent conflict of interest to have been addressed in the best interest of the client. This is also consistent with a registrant's obligation to deal fairly, honestly and in good faith with its clients."

While referral arrangements are a widely used and permissible practice under prescribed conditions, vigilant effort is required to ensure that conflicts of interest are properly addressed, requirements are followed, and proper disclosure is provided.

New Accounts

4

CONTENT AREAS

INTRODUCTION

In this lesson you will learn about your responsibilities and duties concerning new accounts.

This lesson takes approximately 25 minutes to complete.

LEARNING OBJECTIVES

At the end of this lesson, you will be able to:

1 | Discuss the requirements for new accounts.

2 | Describe the identification requirements under securities legislation.

3 | Discuss the identification and documentation requirements under anti-money laundering legislation.

4 | Discuss the identification requirements under the Foreign Account Tax Compliance Act (FATCA).

5 | Explain new account documents including the New Client Application Form (NCAF), Know Your Client (KYC) information, and Relationship Disclosure Information (RDI).

6 | Discuss the requirements concerning client records and why the retention of complete and accurate records is important.

NEW ACCOUNTS

EMDs and Dealing Representatives are responsible for ensuring that all new client accounts that are opened are done so in compliance with the legislation and regulations of the securities regulators and other regulatory authorities, including those for anti-money laundering and terrorist financing (AMLTF) and privacy.

New Client Application Forms ("NCAFs") must be completed and retained on file at the EMD for all new client accounts opened. In order to comply with applicable legislation and regulations, the following items must be incorporated into the NCAF:

- client information (name, address, phone, date of birth, etc.)
- Know Your Client (KYC) information (personal circumstances, financial circumstances, investment needs and objectives, investment knowledge, risk profile, and time horizon)
- client identification information (for securities regulation and AMLTF purposes)
- privacy information and disclosures
- relationship disclosure information (RDI)

IDENTIFICATION REQUIREMENTS

EMDs and Dealing Representatives are required to confirm the identity of new clients under the legislation and regulations of:

- the securities regulators
- the Proceeds of Crime (Money Laundering) and Terrorist Financing (PCMLTF) Act and the Financial Transactions and Reports Analysis Centre of Canada (FINTRAC)

IDENTIFICATION REQUIREMENTS UNDER SECURITIES LEGISLATION/ REGULATIONS

Section 13.2 of NI 31-103 requires that EMDs and Dealing Representatives:

> *"establish the identity of a client and, if the registrant has cause for concern, make reasonable inquiries as to the reputation of the client".*

The requirement to establish the identity of a client would include making a reasonable effort to determine, for example, the identity of beneficial owners (those who are behind the business) when the client is a corporation, partnership, or trust.

NI 31-103 also requires that EMDs and Dealing Representatives:

> *"establish whether the client is an insider of a reporting issuer or any other issuer whose securities are publicly traded".*

An "insider" is anyone who, because of their close relationship to the issuer, is likely to have access to material information about a publicly traded/reporting issuer that is not otherwise available to the public. "Material" means any information that could affect the trading value of a security. Although not exhaustive, below is a list of some individuals or entities most commonly considered "insiders":

- a director or officer of a publicly traded/reporting issuer
- a director or officer of a person or company that is itself an insider or subsidiary of a publicly traded/reporting issuer
- a person or company that beneficially owns or controls more than 10% of the voting rights of the publicly traded/reporting issuer's outstanding voting securities
- a person or company designated as an insider by the regulators

Insiders **do not include** issuers of private placements who offer exempt securities since they are not freely traded like publicly listed companies. While it might be reasonable to assume that insiders would be rare when considering the exempt market, one exception might be when the exempt product is a highly concentrated pooled fund created by a portfolio manager. In such cases, it would be a good idea to enquire whether the client is an insider of the issuer of any securities held by the fund.

When identifying a corporation, partnership, or trust, you must establish:

- the nature of its business
- the identity of any individual who:
  - in the case of a corporation, is a beneficial owner of, or exercises control over more than 25% of the voting rights of the corporation
  - in the case of a partnership or trust, exercises control over the affairs of the partnership or trust

IDENTIFICATION REQUIREMENTS UNDER ANTI-MONEY LAUNDERING AND TERRORIST FINANCING (AMLTF) LEGISLATION/REGULATIONS

FINTRAC Guideline 6E prescribes the requirements you must follow in order to properly establish a client's identity when you open a new account[2]. Under Guideline 6E, identification of clients includes:

- the collection and retention of information to identify all clients

[2] Revised requirements under the Proceeds of Crime (Money Laundering) and Terrorist Financing legislation, regulations, and FINTRAC Guidelines came into force June 2020. The new requirements will be reflected in the next version of the course. For exam purposes, the content in this version of the course will apply.

- third party determination (such as name, address, occupation, date of birth, incorporation number, and place of incorporation)
- screening for politically exposed foreign persons
- recording the intended use of an account
- beneficial ownership and control (the individuals behind the entity)
- if an entity, the control (25% or more of the shares or other ownership) and structure of the entity
- if a trust, the control and structure of the trust
- the names and identity of the individuals who are authorized to act on the account and bind the entity
- if the entity is a corporation, the names and addresses of its directors
- if the client is a not-for profit organization, determination if it is a registered charity. If it is not a registered charity, determination of whether it solicits donations from the public.

The identification documents acceptable for the purposes of establishing the identity of clients are summarized in the table below.

Client Identification Documents		
Client Type	**Identification Documents**	**Timeframe for Collection of ID**
Individuals	Unexpired documents that have a unique identifier and were issued by a government: • birth certificate • driver's license • passport • record of landing or permanent resident card or other similar document • provincial health card (in permitted provinces which do not include Ontario, Manitoba, Nova Scotia, or Prince Edward Island) • certificate of Indian status • provincial or territorial identification card • equivalent foreign identification (e.g. foreign passport) • SIN # (Note: you can refer to a social insurance number (SIN #) to determine the identity of a client, but the SIN number itself must not be provided to FINTRAC on any type of report. Please refer to the fact sheet from the Office of the Privacy Commissioner for best practices for the use of SINs).	Prior to any transactions for the client

Client Identification Documents		
Client Type	**Identification Documents**	**Timeframe for Collection of ID**
Corporations	• the certificate of corporate status • a record that must be filed annually under provincial securities legislation • any other record that confirms the corporation's existence. Examples include: ◦ the corporation's published annual report signed by an independent audit firm ◦ a letter or a notice of assessment for the corporation from a municipal, provincial, territorial, or federal government	Within 30 days of opening the account
Other Entities (other than corporations)	A copy of its founding document such as: • partnership agreement • articles of association or trust indenture	Within 30 days of opening the account

Though most EMDs and other registered firms retain copies of identification documents on file, AMLTF regulations only technically require a copy to be retained:

- if you use an attestation signed by a commissioner of oaths
- if you cannot refer to an original document and must rely on a photocopy or electronic image (i.e. when you use a mandatary)
- for certain non-face-to-face identification methods where a photocopy is needed

In other cases, the Privacy Commissioner of Canada has indicated that businesses should, wherever possible, respect the principle of limiting the collection of information to only that which is necessary. From a privacy perspective, it would be regarded as a best practice to only collect the information relating to the document (type, issuer, date of issue, unique identifier, and expiry date) and not an actual copy.

WHEN YOU CANNOT IDENTIFY A CLIENT

If you cannot confirm the client's identity, you must decline to open the account. In the case of corporations, you must close the account and you may not conduct any subsequent transactions.

NON-FACE-TO-FACE SITUATIONS

When you do not meet the client to view the client's original identification documents, the following applies:

- If your EMD has affiliates and the client has already been identified by the affiliate, you need only record the name, address, and date of birth of the person and confirm that it is the same client identified by the affiliate.
- If the client has not been previously identified by an affiliate, you must gather any 2 of the 3 following items:
  - A personal cheque (minimum $1.00) written on the client's account at a Canadian Bank

- A copy of a client identification document, such as a driver's license or passport, signed by a guarantor or Commissioner of Oaths. The guarantor/Commissioner's document must include:
  - their name
  - their profession
  - their address
  - the type and number of the client identification document
- A credit reference for the client through TransUnion or a similar Canadian credit service agency. The client's name, address, and date of birth must match on the credit reference and the *New Client Application Form* (NCAF).

THIRD PARTY DETERMINATION

A third party is an individual or an entity, other than the account holder, who directs the activity in the account. For example, if an account was opened in one individual's name and the activity in the account was directed by someone else, that someone else is a third party. When you are determining whether a "third party" is involved, it is not about who "owns" the money, but rather about who gives instructions to deal with the money.

If you are required to make a third party determination, you must keep a record of:

- the third party's name, address, and principal business or occupation;
- if the third party is an individual, the third party's date of birth;
- if the third party is a corporation, the incorporation number and place of incorporation;

  and
- in the case of a large cash transaction, the nature of the relationship between the third party and the individual who gives you the cash

  or
- in the case of an account, the nature of the relationship between the third party and the account holder.

POLITICALLY EXPOSED FOREIGN PERSON

A Politically Exposed Foreign Person (PEFP)[3] is any individual who holds or has ever held one of the following offices or positions in or on behalf of a foreign country:

- a head of state or government
- a member of the executive council of government or a member of a legislature
- a deputy minister (or equivalent)
- an ambassador or an ambassador's attaché or counselor
- a president of a state-owned company or bank
- a head of a government agency
- a judge
- a leader or president of a political party in a legislature

[3] Changes to the identification requirements came into force June 2020 to include Politically Exposed Persons (PEPs), both foreign and domestic, and the Heads of International Organizations (HIOs). Changes will be reflected in the next version of the course. For exam purposes, the content in this version of the course will apply.

A PEFP also includes a family member of any of the individuals described above including mother, father, child, spouse, common-law partner, spouse's or common-law partner's mother or father, brother, sister, half-brother, or half-sister. If a client is identified as a PEFP, you must:

- establish the source of the funds
- obtain approval from senior management to accept/keep the account
- perform enhanced monitoring with the purpose of detecting suspicious transactions.

IDENTIFICATION REQUIREMENTS UNDER THE FOREIGN ACCOUNT TAX COMPLIANCE ACT (FATCA)

Under the requirements prescribed in the Income Tax Act of Canada (the ITA) related to the Foreign Account Tax Compliance Act (FATCA), you are required to:

- identify accounts held by clients who are a US person for US tax purposes

Firms are required to:

- report to CRA specified information about the accounts identified as being held by US persons

In general, a person is a US person for US tax purposes if that person is a US resident or a US citizen. In order to identify new clients under FATCA, you and your EMD must ask clients to certify whether he or she is a US person at the time that the account is opened.

Figure 4.4

This information is usually recorded into a section of the New Client Application Form (NCAF). You are then responsible for considering the reasonableness of the client's certification based on the other information provided by the client when opening the account. Where there is reason to question a client's US status, for example where they have a US address but do not indicate they are a US person for tax purposes, your firm will expect you to ask the client to provide supporting documentation.

NEW ACCOUNT DOCUMENTS

In order to open a new account, you are required to collect a plenitude of detailed information about the client and the account. The New Client Application Form (NCAF), including KYC information, and other forms must be completed prior to opening each new account. The client must sign and date the new account forms and a copy of the completed form(s) must be provided to the client. The new account forms will generally include the:

- New Client Application Form (NCAF), including the Know Your Client (KYC) information
- Relationship Disclosure Information
- Subscription Agreement

- Accredited Investor Certificate (where applicable)
- Eligible Investor Certificate (where applicable)
- Family, Friends, and Close Business Associates (FFBA) Certificate (where applicable)
- Risk Acknowledgement Form (where applicable)
- Breakdown of financial assets and net assets of the client (recommended)

NEW CLIENT APPLICATION FORM (NCAF) AND KNOW YOUR CLIENT (KYC) INFORMATION

New Client Application Forms ("NCAFs") must be completed and retained on file for all new client accounts opened. Similar requirements apply under legislation for securities, taxation, anti-money laundering and terrorist financing (AMLTF), and privacy. When you open a new account for a client, you must collect and record information about the client and the account into the NCAF including:

- **Client information:** including name, address, phone, date of birth, social insurance number (S.I.N.), etc.
- **Know Your Client (KYC) information:** personal circumstances, financial circumstances, investment needs and objectives, investment knowledge, risk profile, and time horizon
- **Client Identification (ID) information:** under securities and AMLTF legislation
- **Privacy:** information and disclosures
- **Information Applicable to the Account/Type:** type, ownership, spouse, beneficiary, banking information, etc.

In some cases, the information needed to open a new account will all be recorded into one *New Client Application Form* ("NCAF"). In other cases, separate documents may be used to capture the different sets of data that must be collected for each new account. Thus, a number of forms may be required in order to open a new account for a client.

RELATIONSHIP DISCLOSURE INFORMATION (RDI)

The Relationship Disclosure Information (RDI) is the registered firm's document which explains the relationship with the client. The purpose of the RDI is to describe the relationship between the EMD, the client, and the Dealing Representative.

Under regulatory requirements, the RDI must be provided to all clients at the time they open a new account and must include all information that a reasonable investor would consider important about their relationship with their registered firm and Dealing Representative. The securities regulators have also prescribed specific sections that must be incorporated into the RDI including:

- Advisory Relationship
- Products and Services
- Conflicts of Interest
- KYC and Suitability (including the obligation to put the client's interest first when determining suitability)
- Compensation and Benefits
- Client Reporting
- Benchmarks

When you open a new account for a client, you are required to provide and explain the Relationship Disclosure Information (RDI). You are responsible for helping the client understand the nature of the relationship between the you, the firm, and the client.

Under the RDI requirements, you are expected to:

- spend sufficient time with your clients to explain the RDI information
- discuss the RDI information with your clients in an in-person or telephone meeting
- be prepared to answer any questions
- follow their firm's policies and procedures to evidence that you have done so

Relationship Disclosure Information (RDI)

RDI Section	Description
Account Type	• describes the nature/type of account • includes an explanation of how and where the client's assets are held
Advisory Relationship	• describes the nature of the advisory relationship • establishes responsibility for investment advice and investment decisions
Products & Services	• describes the products and services provided by the registered firm • provides specific disclosure about: ○ liquidity and resale restrictions ○ investment fund management expense fees and ongoing fees ○ other ongoing fees and expenses ○ proprietary products ○ mutual funds of a related investment fund manager
Cash & Cheques	• describes how the registered firm receives and handles deposits and cheques from clients • establishes who the payee is for deposits and cheques
Risks	• describes the risks that a client should consider when: ○ making investment decisions ○ borrowing to invest
Conflicts of Interest	• describes the conflicts of interest that the registered firm is required to disclose to the client
Suitability	• describes the registered firm's suitability obligation including: ○ the events that will trigger a suitability assessment ○ the obligation to put the client's interest first when determining suitability
Know Your Client (KYC)	• defines the terms for the KYC information collected • describes how the KYC information will be used in relation to specific investments that may be recommended or accepted for the client's account • describes how the KYC information will be used when assessing suitability

Relationship Disclosure Information (RDI)	
RDI Section	**Description**

Client Reporting	• describes the frequency and content of reporting that will be sent to the client for:
	  ○ Trade Confirmations
	  ○ Client Account Statements
	  ○ Report on Charges and Other Compensation
	  ○ Performance Report

Compensation and Benefits	• describes the nature of compensation that the firm may receive, for example:
	  ○ commissions at the time of purchase
	  ○ trailer fees on an ongoing basis
	• refers to other sources for more specific information on compensation
	• describes the benefits to the firm from other parties in connection with the client's investment with the firm

Transaction Charges	• describes the types of transaction charges that the client may be required to pay

Impact on Returns	• explains the impact on a client's investment returns from:
	  ○ expenses and ongoing fees (described under Products and Services)
	  ○ charges (described under Transaction Charges)
	• includes the effect of compounding over time

Benchmarks	• explains how investment performance benchmarks might be used to assess the performance of the client's investments • provides investment performance benchmarks available from the firm
Complaint Obligations	• describes the firm's obligations with respect to complaints and the process for pursuing recourse with the Ombudsman for Banking Services and Investments (OBSI)

When you open a new account for a client, the regulators want you to encourage your clients to:

- notify you about any changes to their circumstances and account information
- review their statements, trade confirmations, performance reports, compensation summaries, and other literature you and your firm provide

While the RDI is not required to be incorporated into the New Client Application Form (NCAF), exempt market dealers often incorporate a section into their NCAF where the client acknowledges their receipt of the RDI. Other alternative methods can be used to evidence the client's receipt of the RDI. You must follow your firm's policies and procedures related to RDI.

Sample RDI
SIGNATURE SECTION CLIENT AGREEMENT
I/WE HAVE RECEIVED/DISCUSSED THE OTHER BUSINESS ACTIVITIES DISCLOSURE (IF APPLICABLE) AND THE RELATIONSHIP DISCLOSURE INFORMATION BOOKLET, WHICH CONTAINS IMPORTANT INFORMATION CONCERNING CLIENT RELATIONSHIP, ACCOUNT OPENING AGREEMENT, INVESTMENT SUITABILITY, LEVERAGING, AND DEALER/ADVISOR COMPENSATION.
CLIENT(S) INITIAL(S)

PRIVACY CONSENT

Under the Personal Information Protection and Electronic Documents Act (PIPEDA) and similar privacy legislation of the provinces and territories, you and your EMD are subject to requirements governing the privacy of their clients' personal information. Under these requirements, firms must obtain consent from clients in order to collect, use, or disclose their personal information. Registered firms, such as exempt market dealers, normally incorporate their privacy policy into a section of the New Client Application Form (NCAF) where the client acknowledges their consent.

Sample Privacy Consent
SIGNATURE SECTION CLIENT AGREEMENT
I/WE CONSENT TO MY/OUR PERSONAL INFORMATION BEING COLLECTED, HELD, USED AND DISCLOSED BY <DEALER> IN THE WAYS AND FOR THE PURPOSES IDENTIFIED IN THE PERSONAL INFORMATION POLICY AVAILABLE ON DEALER WEBSITE www.DEALER.ca
CLIENT(S) INITIAL(S)________

CLIENT RECORDS

As a Dealing Representative, you are required to retain complete and accurate records that can be accessed for review and audit by your EMD and the securities regulators. Should you be subject to investigation for any reason, the records you retain concerning your relationships with your clients will also serve as evidence that you are a conscientious and knowledgeable Dealing Representative and will provide proof that you acted fairly, honestly, and in good faith with your clients.

Your client files should contain complete and accurate records of the following at minimum:

- all required applications and forms, including the *New Client Application Form* (NCAF)/Know Your Client (KYC) form(s)
- all written disclosures that you are required to provide to clients
- records to support how you qualified your clients for prospectus exemptions (e.g. accredited investor exemption, offering memorandum exemption)
- all pertinent records for every transaction recommended and/or executed by you
- evidence of other required disclosures, for example disclosure of transaction fees and/or charges
- all correspondence to and from the client in connection with the account(s)

Retaining complete and accurate client records are critical and you should:

- Understand the regulatory requirements and follow your EMDs policies thoroughly. When in doubt, contact compliance. They are there to help.
- Take detailed notes of every discussion you have with clients, with issuers, with client tax experts or lawyers, with your compliance department, and with any other individual or entity that had any impact on the service you provided or recommendations you made for a client. If you are ever subject to an investigation interview or required to provide testimony in a hearing or court, documentary evidence recorded at the time the service or recommendation was provided will be your best defense.
- Follow standard procedures for every client. For example, if every one of your client files contains a signed disclosure for outside activities and research on the product you recommended to the client, it will be possible to claim that disclosing OAs and discussing the features of a product are a “standard operating practice” for you. It will then be more difficult for a client to claim that they did not receive proper disclosure or adequate information about the product that was recommended.

Client Assets

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CONTENT AREAS

Client Assets

INTRODUCTION

In this lesson you will learn about the requirements concerning client assets.

This lesson takes approximately 5 minutes to complete.

LEARNING OBJECTIVES

At the end of this lesson, you will be able to:

1 | Describe the EMDs responsibilities for client assets.

CLIENT ASSETS

EMDs are responsible for safeguarding the cash, securities, and other property that it holds for clients so that it is fully and completely accounted for and protected against material loss. All cash, securities, and other property held for clients must be held in trust for clients and be segregated and held separately and apart from the EMDs own property.

As established in NI 31-103 Section 14.6, EMDs must hold client assets:

a. "separate and apart from its own property,
b. in trust for the client, and
c. in the case of cash, in a designated trust account at a Canadian financial institution, a Schedule III bank, or a member of IIROC."

The EMDs books and records must accurately record its clients' assets held in trust and records must be complete, accurate, and accessible to the regulatory authorities.

Registered Plans 6

CONTENT AREAS

INTRODUCTION

In this lesson you will learn about the requirements concerning registered plans.

This lesson takes approximately 5 minutes to complete.

LEARNING OBJECTIVES

At the end of this lesson, you will be able to:

1 | Discuss registered savings plans.

2 | List the four most common registered plans.

3 | Explain registered retirement savings plans (RRSPs).

4 | Explain tax-free savings accounts (TFSAs).

5 | Explain registered retirement income funds (RRIFs).

6 | Explain registered education savings plans (RESPs).

7 | List qualified investments for registered plans.

8 | Explain the penalties for non-qualified investments.

9 | Explain the penalties for prohibited investments.

10 | Describe the role of the trustee in terms of tax liabilities.

REGISTERED PLANS

Under the Canadian tax system, the federal government offers a number of registered plans with tax incentives to encourage savings. Investors use registered plans to achieve more favourable tax treatment and to attract government grants in applicable circumstances. You should be comfortable with how registered savings plans can be used as part of an effective investment strategy for clients and with the eligibility requirements for holding securities within a registered plan.

The four most common types of registered plans are:

- **Registered Retirement Savings Plans (RRSP)**: defer the payment of taxes to a time in the future when it is expected that the rate of tax for the recipient will be lower
- **Tax-Free Savings Accounts (TFSA):** eliminate the taxes on the amount invested and on any income earned within the account
- **Registered Retirement Income Funds (RRIF):** convert large taxes on lump sum savings to smaller payments and lower rates over time
- **Registered Education Savings Plans (RESP):** defer tax to a time in the future when the student will be earning little income and paying a lower tax rate and attract government grants

REGISTERED RETIREMENT SAVINGS PLANS

By investing in a registered retirement saving plan (RRSP), your client is able to save and earn income on a tax-deferred basis within certain limits. The RRSP is meant to provide an incentive for individuals to save money for their retirement years. Two of the primary advantages of an RRSP are:

- the contributions to the RRSP are tax deductible
- investment earnings within the plan are not taxed until the funds are withdrawn

TAX-FREE SAVINGS ACCOUNTS

The tax-free savings account (TFSA) is a savings vehicle which allows investors to earn investment income on a tax-free basis. Unlike RRSPs, contributions to a TFSA are not tax deductible and any income that is withdrawn from the plan is not taxed.

REGISTERED RETIREMENT INCOME FUNDS

In the year that an investor turns 71 years of age, their RRSP matures and it must be converted. The investor must choose one of the following conversion options:

- De-register the RRSP and receive a lump-sum cash payment
- Convert the RRSP into a registered retirement income fund (RRIF)
- Purchase an annuity

A RRIF acts the same as an RRSP in the sense that any income earned in the RRIF is tax-deferred until paid out. However, unlike an RRSP, clients cannot make new contributions to a RRIF and a minimum amount of income from the RRIF must be paid to your client each year which is taxable.

REGISTERED EDUCATION SAVINGS PLANS

The purpose of registered education savings plans (RESPs) is to help parents and grandparents plan and save for their children's and grandchildren's future education. These plans are legal contracts between a subscriber (like your client) and a plan promoter (like a bank or trust company). Your client can make contributions to the plan of up to $50,000 per beneficiary over a maximum of 31 years. The federal government provides a grant of up to $500 for each year the beneficiary is under 18, to a maximum of $7,200 per beneficiary. The investment income earned in an RESP is not taxed until it is withdrawn. Once the beneficiary enrolls as a full-time student in a qualifying educational program at a qualifying post-secondary institution, money can be withdrawn from the RESP. A portion of the payments are taxable in the hands of the beneficiary at that time based on the income accumulated in the plan including the government grant.

QUALIFIED INVESTMENTS

Only specific types of investments are allowed to be held in registered plans. Some of the common types of qualified investments are outlined in the table below.

Qualified Investments
• money and deposits (including foreign currencies) • Canadian government bonds (federal, provincial, or municipal) • guaranteed investment certificates (GICs) and term deposits • securities listed on a designated stock exchange in or outside Canada (e.g. TSX, NYSE) • mutual fund trust units and mutual fund corporation shares • certain Canadian mortgages • certain corporate bonds • certain shares of private corporations • registered investments

REGISTERED INVESTMENTS

A registered investment is a type of pooled investment vehicle which has been pre-approved by the Canada Revenue Agency as being a qualified investment for registered plans. These types of investments take one of four forms:

- mutual fund trusts
- pooled fund trusts
- mutual fund corporations
- investment corporations

There are also "quasi" variations of each of these four types. Each year, the CRA publishes a list of registered investments in the Canada Gazette and online.

PENALTIES FOR NON-QUALIFIED INVESTMENTS

If the exempt product your client holds in his or her registered plan is "non-qualified", the client will be subject to a penalty tax. For an RESP, if your client holds non-qualified investments in the plan, the registered status may be revoked and all income or gains earned may be subject to tax at the top marginal rate. If the RESP is not revoked but still holds non-qualified investments, the plan will pay a 1% penalty tax on the future market value of the non-qualified investments (as measured at acquisition) for each month that the plan holds the investments.

PROHIBITED INVESTMENTS

Some specific investment types have been prohibited by the CRA from being held in registered plans. Generally, a prohibited investment is one that is "closely-held", such as:

- Closely connected debts (personal debts not including a mortgage insured by an approved insurer).
  - This is a debt of the individual who controls the registered plan. Note that this does not include a mortgage insured by the Canada Mortgage and Housing Corporation (CMHC) or an approved private insurer.

- Corporation shares, trust units, or partnership units where the annuitant or related parties own a significant interest.
    - Shares, trust units, or partnership units bought into a registered plan cannot represent 10% or more of the value of the corporation, trust, or partnership either alone, or together with related parties. It is therefore important to understand not only what your client is investing in, but also the investments of their spouses, children, or other related persons. A debt or share of, or an interest in, a corporation, trust, or partnership with which the registered plan holder does not deal at arm's length may also be prohibited.

PENALTIES FOR PROHIBITED INVESTMENTS

There are two types of penalties for holding a prohibited investment in a registered plan:

- A 50% tax payable by the client on the total future market value of the prohibited investment. This tax may be refunded if the investment was acquired in error and is disposed of by the end of the year after the year it was acquired.
- A 100% tax on any income or gains earned on the investments. This tax may be waived where the CRA determines it should not be applicable.

In cases where a client holds prohibited investments, it is important that they seek professional tax advice to transition out of the plan.

TRUSTEE

Except in the case of a TFSA, the Income Tax Act of Canada requires that savings through a registered vehicle be held by a trustee. Where a trustee has transacted any business or permitted any situation to exist that created a tax liability, it will be responsible for filing an information return with a payment for any balance due no later than 90 days after the end of the calendar year.

UNIT SUMMARY

Congratulations, you have reached the end of Unit 4: Dealing with Clients.

In this unit you covered:

- Lesson 1: Standard of Conduct
- Lesson 2: Establishing the Relationship with the Client
- Lesson 3: Conflicts of Interest
- Lesson 4: New Accounts
- Lesson 5: Client Assets
- Lesson 6: Registered Savings Plans

Now that you have completed these lessons, you are ready to assess your knowledge with a 10-question quiz. To start the quiz, return to the IFSE Landing Page and click on the Unit 4 Quiz button.

UNIT 5

THE PRIVATE PLACEMENT PROCESS

INTRODUCTION

In this unit you will learn about the process for bringing a private placement to market and closing the financial transaction.

This unit takes approximately 1 hour and 5 minutes to complete.

Lessons in this unit:

1. The Engagement Letter
2. Agency Agreement
3. Subscription Agreement
4. Closing the Financial Transaction

The Engagement Letter 1

CONTENT AREAS

INTRODUCTION

In this lesson you will learn about the *Engagement Letter* and the important elements of the engagement between the EMD and the issuer.

This lesson takes approximately 20 minutes to complete.

LEARNING OBJECTIVES

At the end of this lesson, you will be able to:

1 | Provide an overview of private placements.

2 | Define the purpose of the *Engagement Letter*.

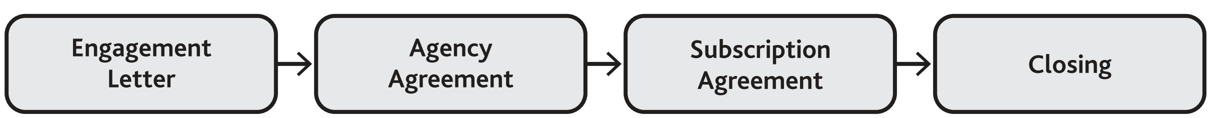
3 | Explain the importance of knowing what transactions are covered.

4 | Describe the components of the *Engagement Letter* including fee arrangements, expenses, terms, and indemnification clauses.

OVERVIEW OF PRIVATE PLACEMENTS

Many EMDs will have a corporate finance team to manage private placements including structuring products, conducting due diligence, and producing documentation. The Dealing Representatives will have little involvement in the inception of private placements under this business model. However, in some cases, such as at small firms that do not have a corporate finance team, the Dealing Representative may be more involved. Regardless of the extent of your involvement, it is important to have a general understanding of the process and components of a private placement.

Figure 5.1



The private placement starts with the Engagement Letter, then the Agency Agreement and Subscription Agreement, and culminates with the closing of the transaction.

THE ENGAGEMENT LETTER

The *Engagement Letter* is the formal contract whereby the issuer retains the EMD to provide its services. It is a critical document because it is binding in nature and sets out the formal obligations of both the EMD and the issuer in connection with the proposed commitment to raise capital.

The *Engagement Letter* includes the following components:

- covered transactions
- fee arrangements and broker warrants
- nature of the engagement
- expenses
- term of engagement

- fee tail
- right of first refusal
- indemnification

COVERED TRANSACTIONS

One of the primary issues addressed in the *Engagement Letter* is the transactions that are covered. The covered transactions drive the process and form the basis of the EMD's fee. The EMD will try to cast a wide net to cover any type of capital raising transaction, which triggers the issuer's obligation to pay the EMD's success fee. Similarly, an issuer will want the covered transactions to be more narrowly defined; specifying the EMD's exact duties to raise a specified amount of capital in a specified form (such as debt versus equity).

EXAMPLE

Fairbid Corp. retains Blue Sky Capital Inc. to raise $2 million of financing. Blue Sky, the EMD, would want the covered transactions to include any combination of debt or equity. If Blue Sky was only able to source $2 million of debt and the covered transaction in the Engagement Letter speaks only to raising equity, then legally speaking, Blue Sky has not fulfilled its mandate and no compensation would be payable if a debt fundraising transaction were to close.

For the issuer to ensure that certain transactions are not unintentionally included, the definition of a covered transaction should be carefully negotiated to account for particular carve-outs. For example, where the minimum amount of capital to be raised is $2 million in equity, this should be specified such that if the EMD raises only $1 million of equity, the EMD would not be entitled to compensation. In addition, there may be circumstances where certain subscribers should be specifically excluded from covered transactions. For example, where the issuer has pre-existing relationships with certain subscribers, it would not be appropriate for the EMD to receive any compensation for those pre-existing subscribers who would have subscribed to the offering regardless.

The scope of the services to be rendered by the EMD should also be established in explicit terms in order to ensure that that the issuer's expectations of the EMD are fully satisfied.

FEE ARRANGEMENT AND BROKER WARRANTS

Another critical component of the engagement is the negotiation of the fee arrangement, which is comprised of the following 3 elements:

- work fee
- cash compensation
- broker warrant

WORK FEE

EMD's will often seek a non-refundable "work fee" to cover their basic costs. The exact amount depends on the size and complexity of the proposed offering. Commonly, the work fee for a $2 million offering would be in the range of 1%, or $20,000. In some situations, the EMD will waive the work fee in order to induce the issuer to sign the *Engagement Letter*.

CASH COMPENSATION

The primary source of compensation for the EMD will be a success fee for a completed offering. The success fee can range anywhere from 2% to 10% of the total amount raised depending on whether the offering is debt (attracting a lower success fee) or equity (attracting a higher success fee).

EXAMPLE

Blue Sky Capital Inc. negotiates a 5% success fee with their client Fairbid Corp. On a $2 million equity offering, they would receive $100,000.

BROKER WARRANT

In a private placement, it is common for the issuer to issue warrants to the EMD as consideration for their services. This allows the EMD to acquire a certain portion of the equity offering, for a period of time (usually stated in years), at the same price offered to third parties. The terms of the broker warrants issued to the EMD are negotiated in advance and are specifically set out in the *Engagement Letter*. Broker warrants often represent one of the most valuable components of the EMD's and Dealing Representative's compensation. It is not uncommon to see anywhere from 5% to 10% broker warrant entitlement to the EMD with a lifespan of 2 to 3 years.

EXAMPLE

Blue Sky Capital Inc. is negotiating a $2 million offering in the private market for its client Fairbid Corp. The equity offering is being done at $5 per share (400,000 common shares issued). They agree to a 5% broker warrant entitlement with a 2 year lifespan. Blue Sky is entitled to receive 20,000 broker warrants at the purchase price of $5, the value of which equals $100,000. One year into the 2 year term, Fairbid Corp. goes public and its shares trade at $15. The value of the broker warrant increases to $200,000 (20,000 broker warrants × $15 = $300,000 less the exercise price of $100,000).

In this example, the broker warrants provide more compensation than a 5% cash *commission.*

Often, EMDs will build up a pool or book of broker warrants from multiple placements which can provide significant future value to the EMD and the Dealing Representative. It is important to note that the securities commissions and regulators have rules on the transferability of broker warrants.

NATURE OF THE ENGAGEMENT

The Engagement Letter should clearly set out whether the EMD's engagement by the issuer is:

- exclusive: the issuer may not retain the services of any other EMD during the term
- non-exclusive: the issuer may retain the services of other EMD's during the term
- non-exclusive with a protected list: the issuer may engage the services of other EMD's during the term, but the EMD will be protected in terms of compensation for those investors identified on the protected list

Best practice dictates that the nature of the mandate is clearly set out in writing in the *Engagement Letter* with specific references concerning the "exclusive", "non-exclusive" or "non-exclusive with a protected list" nature of the engagement. The mandate should never be vague and the component establishing the nature of the engagement must be consistent with the other sections of the agreement, specifically in relation to the provisions concerning the EMD's compensation.

NON-EXCLUSIVE

If the nature of the engagement is not specified, it will likely be deemed to be non-exclusive, giving the issuer the right to engage other EMDs during the term of the *Engagement Letter*. The first EMD receives compensation only for those investors it introduces and for which there is a closing during the term.

EXCLUSIVE

If the mandate specified is exclusive, it will entitle the EMD to exclusive representation of the issuer during the term of the *Engagement Letter* and the right to receive compensation for any amounts raised during the term, regardless of how the investment is procured, whether the EMD introduces or procures the investor or the investor comes from another source without the EMD's involvement.

NON-EXCLUSIVE WITH PROTECTED LIST

The non-exclusive with protected list mandate is a hybrid, occupying the middle ground between the exclusive and non-exclusive mandate, where the issuer is free to retain the services of other EMDs during the term of the *Engagement Letter*, but the first EMD will be compensated on a success basis for investors they:

- specifically identified on the protected list (the protected list is usually appended to the *Engagement Letter*)
- procured or introduced and who are not identified on the protected list

LIMITED PROTECTED LIST

A slight variation to the protected list mandate is the limited protected list mandate, where the EMD is to solicit only those investors specifically identified on the protected list. This type of mandate is often used where the EMD has no pre-existing relationship with the issuer, but approaches them because the EMD believes it can source funding from a specific investor. The issuer may be cautious about granting a mandate to the EMD other than a limited one specifically to investor(s) on the protected list.

THE CAVEATS WITH THE NON-EXCLUSIVE MANDATE

Unsophisticated or first-time issuers sometimes assume that a non-exclusive engagement is in their best interests and try at the outset to resist an exclusive engagement. The issuer's reasoning could be that a non-exclusive engagement could provide the issuer with more flexibility to engage more "feet on the street" to raise capital through various EMD's simultaneously. However, the issuer should consider the negative consequences of "deal collision" that could result where two different EMDs approach the same investor at the same time. The issuer and EMD may only have one chance to make a good first impression with a potential investor and an uncoordinated, duplicative marketing approach may reflect poorly on the investment opportunity. As a Dealing Representative, you should be prepared to explain the advantages, disadvantages, and appropriateness of each mandate.

Optimal results for a successful offering are achieved when the EMD has a proven track record of raising capital in the issuer's industry, such as mining or biotech, and the EMD is in a position to create a professional, coordinated, and controlled auction for the investment opportunity.

EXPENSES

Another important component for negotiation is the reimbursement of expenses to the EMD in connection with the offering. While the EMD will want to have all expenses connected with the offering reimbursed, the issuer will want some control. The issuer may require that the EMD obtain prior written approval for expenses above a certain dollar threshold and may put a dollar cap on legal and other professional expenses. The issuer may also require that expenses be paid out of the closing proceeds, only if a successful closing occurs.

TERM OF ENGAGEMENT

Negotiation of the engagement will always include the term of the engagement. Common practice is to state the term of the engagement as a fixed duration in the *Engagement Letter*, usually not less than 1 year with automatic renewal rights thereafter. Commonly, there are provisions which allow either the EMD or the issuer to terminate the mandate early without cause, usually on 30 days prior written notice.

FEE-TAIL

The fee-tail is a provision in the *Engagement Letter* which states that if the engagement is terminated by either the EMD or the issuer, and a transaction is consummated with a party who was "introduced" by the EMD within a designated period after termination, the EMD will be entitled to payment of its fees in full as if the engagement was not terminated. The designated period of time, known as the "tail period", is typically between 12 and 24 months.

RIGHT OF FIRST REFUSAL

The Right of First Refusal (ROFR) is another important section of the *Engagement Letter*. When ROFR is granted, after the successful completion of the offering, the EMD is entitled to the right of first refusal to act as the exclusive advisor to the issuer on any future offering over a specified period of time, usually no longer than 2 years. It requires the issuer to offer the EMD the right to act as financial advisor on a future offering before another EMD can be retained.

INDEMNIFICATION

In most *Engagement Letters*, the issuer will agree to indemnify the EMD from any claims which the EMD suffers as a result of the engagement, other than willful misconduct or gross negligence of the EMD. The indemnification provisions are important for a number of reasons, not the least of which is because the EMD brings investors to the investment based on the due diligence information provided by the issuer, including financial and operational data. If the due diligence data turns out to be incorrect, and the investors suffer a financial loss, the EMD may be sued by investors. The indemnification provisions provide the legal basis for the EMD to seek recourse against the issuer.

Agency Agreement 2

CONTENT AREAS

The Agency Agreement

INTRODUCTION

In this lesson you will learn about the *Agency Agreement* between the EMD and the issuer.

This lesson takes approximately 20 minutes to complete.

LEARNING OBJECTIVES

At the end of this lesson, you will be able to:

1 | Define the purpose of the *Agency Agreement*.

2 | Describe the components of the *Agency Agreement* including terms of the offering, closing conditions, representations and warranties, and indemnification.

THE AGENCY AGREEMENT

The *Agency Agreement* is the formal agreement between the issuer and the EMD (the "agent") whereby the issuer agrees to appoint the agent, and the agent agrees to act for the issuer in connection with the sale of securities.

Not every offering will use a formal *Agency Agreement*. In some instances, especially where the size of the offering is relatively small, the *Engagement Letter* together with a more comprehensive *Subscription Agreement* will be used as the main documents to establish the relationship between the issuer, the EMD, and investors. It is common practice to use a formal *Agency Agreement* where there are multiple investors and the offering is sizeable in terms of dollar amount. The *Agency Agreement* will supersede and replace the *Engagement Letter* upon signing of the *Agency Agreement*.

TERMS OF THE OFFERING

The *Agency Agreement* is the formal agreement which establishes the specific terms of the offering of securities including the amount to be offered, price, and jurisdictions of the offering. In contrast, the *Engagement Letter* will very often leave the specific terms of the offering undefined and subject to negotiation and acceptance by the issuer at a later date.

DEALER COMPENSATION

The *Agency Agreement* establishes the EMD's compensation as negotiated in the *Engagement Letter*, but will set these terms out in greater commercial detail.

SCOPE OF SERVICES

The *Agency Agreement* establishes the scope of services to be provided by the EMD as negotiated in the *Engagement Letter* including specifics as to whether the relationship is exclusive or non-exclusive. In the *Agency Agreement*, the EMD also agrees to use its commercially reasonable best efforts to raise the funds according to the terms set out in the agreement.

CLOSING CONDITIONS

The *Agency Agreement* specifies the closing date and the steps that the issuer agrees to take to ensure a successful closing. Specifically, the issuer will:

- ensure the accuracy of the representations and warranties on closing
- agree to allot a sufficient number of securities to satisfy the offering and the EMD's broker warrant compensation
- agree to make all securities filings required in connection with the offering on a timely basis
- agree to operate the business in the ordinary and usual course during the period between the signing of the *Agency Agreement* and closing
- provide the principal closing items and deliverables

REPRESENTATIONS AND WARRANTIES

The *Agency Agreement* includes representations and warranties that the issuer makes to the EMD on its own behalf and on behalf of each subscriber/investor in the offering. The representations and warranties concern the affairs of the issuer and are the principal contractual protection that the EMD and the subscribers receive about the issuer and its affairs. Some of the more important representations and warranties include:

- authorized and issued securities of the issuer
- disclosure of any pending or threatened litigation claims
- a listing of and confirmation of good title to the issuer's property (of particular importance in real property, mining, or intellectual property transactions where the status of good title to the issuer assets is of particular significance)
- confirmation of the accuracy of financial statements
- confirmation of the payment of taxes

The representations and warranties in an *Agency Agreement* are typically extensive. Where an *Agency Agreement* is used, the representations and warranties contained in the *Subscription Agreement* will typically be less extensive.

INDEMNIFICATION

The indemnification provisions in the *Agency Agreement* provide a contractual remedy and outlines the steps required in the event a claim is made concerning a breach of any representation of warranty or covenant.

It is important to note that the subscribers (investors) are not a party to the *Engagement Letter* or the beneficiary of its terms. The *Agency Agreement* is the contractual link between each subscriber (investor) and the issuer when it comes to representations, warranties, and covenants as well as indemnification provisions. Most claims are made by the investor against the advisor or the EMD.

Subscription Agreement 3

CONTENT AREAS

INTRODUCTION

In this lesson you will learn about the *Subscription Agreement* between the issuer and the investor.

This lesson takes approximately 10 minutes to complete.

LEARNING OBJECTIVES

At the end of this lesson, you will be able to:

1 | Define the purpose of the *Subscription Agreement.*

2 | Describe the components of the *Subscription Agreement* including the description of the securities, and representations and warranties.

THE SUBSCRIPTION AGREEMENT

The *Subscription Agreement* is the contract between the issuer and the investor (called the "subscriber") who offers to purchase a specified number of the issuer's securities.

The *Subscription Agreement* includes the following components:

- description of securities
- name of subscriber
- exemption to be used
- representations and warranties
- closing arrangements
- EMD disclosures

DESCRIPTION OF SECURITIES

The description of securities in the *Subscription Agreement* includes:

- security type (i.e. equity, debt, convertible debt, etc.)
- number of securities subscribed for by the subscriber
- subscription price (both on a per security basis—such as $10 per common share—and on an aggregated basis—such as 100 common shares at $10 = $1,000)

Other terms of the offering will also be included, such as whether it is a "Min-Max" offering. A Min-Max offering establishes:

- the minimum dollar amount and number of securities which must be subscribed for in aggregate to enable the first tranche of the financing transaction to close
- the maximum dollar amount and number of securities which will be subscribed for in aggregate, over and above which no further securities will be issued in connection with the offering

NAME OF THE SUBSCRIBER

The *Subscription Agreement* contains a section where the name and details of the subscriber are collected including:

- the name of the subscriber
- how the securities are to be registered (e.g. the subscriber may want the securities registered in his/her name, his/her broker's account, in an RRSP, or TFSA, etc.)

This information is needed to discern the beneficial or ultimate owner of the securities to determine, among other things, the private placement exemption to be used and identity of the client.

EXAMPLE

Joe is one of the individuals named on the protected list of the Engagement Letter between Fairbid Corp. and Blue Sky Capital Inc. He buys $200,000 securities under the accredited investor exemption. The Subscription Agreement captures his wish to have the securities registered in his broker's account.

PROSPECTUS EXEMPTION

The subscriber must confirm the exact prospectus exemption that he/she is relying on to subscribe for the securities in the private placement (e.g. accredited investor exemption). This is of utmost importance to the EMD in fulfilling their obligation to qualify the client for exemption. This section will often be the longest portion of the *Subscription Agreement* and will cover domestic, U.S., and foreign subscriber scenarios.

REPRESENTATIONS AND WARRANTIES

The *Subscription Agreement* includes representations and warranties that protect both the issuer and the subscriber. The main representations and warranties in a *Subscription Agreement* are summarized in the table below.

Subscription Agreement Representations and Warranties	
The subscriber, by his/her execution of the *Subscription Agreement*, represents, warrants, and covenants to the issuer and/or the Agent as follows:	• the subscriber is purchasing the securities for their own account and not on behalf of anyone else • the subscriber provides detailed representations as to their status to partake in the available prospectus exemption • the subscriber has been advised of any statutory hold periods to trade the securities • the securities are illiquid and the subscriber will not sell the shares (in accordance with applicable securities laws) • the subscriber is aware that the investment is risky, and has been advised of the "risk factors" that are enumerated in the *Subscription Agreement* • the proceeds tendered by the subscriber are subject to Anti-Money Laundering/Proceeds of Crime legislation • the *Subscription Agreement* is not a binding agreement until accepted by the issuer • the subscriber is not relying on tax advisors or legal counsel of the issuer and has been advised to obtain independent legal and tax advice • the length of period the representations and warranties "survive" closing

CLOSING ARRANGEMENTS

The *Subscription Agreement* specifies the particulars about the closing of the offering including:

- the anticipated closing date
- documents and funding which are expected to complete the closing
- specific payment instructions in terms who is to be paid and how (the EMDs trust account, whether a certified cheque is required, etc.)

EMD DISCLOSURE

The *Subscription Agreement* includes disclosure concerning:

- the cash and broker warrant compensation to be paid to the EMD
- any conflicts of interest

Closing the Financing Transaction

4

CONTENT AREAS

INTRODUCTION

In this lesson you will learn about closing the financing transaction.

This lesson takes approximately 15 minutes to complete.

LEARNING OBJECTIVES

At the end of this lesson, you will be able to:

1 | Describe the due diligence process required on closing.

2 | List the required closing documents.

3 | Describe the obligations of legal counsel.

4 | Understand the role of the legal opinion on closing.

CLOSING THE FINANCING TRANSACTION

The closing represents the completion and culmination of the financing transaction and involves a series of steps whereby:

- the securities are issued by the issuer to the subscribers
- payment is made by the subscribers to the issuer
- the EMD is paid its success fees, expenses, and broker warrants

THE CLOSING DUE DILIGENCE SESSION

EMDs are obligated to conduct due diligence on any investment product they offer for sale to the investing public as part of their suitability and gatekeeper obligations. The EMD must conduct a thorough due diligence examination of the issuer and the offering in order to ensure that the exempt security is a credible product for investors.

Due diligence is conducted by obtaining the required information about the issuer over a period of time before the closing, in written form, supported by various documents. Commonly, a *Due Diligence Checklist* is used and the documents to support the due diligence conducted are retained in a *Due Diligence Binder*.

Once all items on *the Due Diligence Checklist* have been addressed, due diligence is closed. Commonly, a *Due Diligence Question Session* is convened with management of the issuer in order to close the due diligence. The session is convened with representatives from the EMD's and issuer's management, as well as counsel from both the EMD and the issuer. Most often, the session takes place immediately before closing and is facilitated by way of a conference call which is taped and transcribed.

The EMD has a significant role in formulating the questions for the *Due Diligence Question Session* and for following up on any items that arise in the session. The transcript of the *Due Diligence Question Session* is retained by counsel for the EMD.

THE ROLE OF COUNSEL FOR THE EMD ON CLOSING

The role of counsel for the EMD is to ensure that the interests of the EMD and subscribers are protected in connection with the subscription for securities. As such, counsel for the EMD is usually involved in:

- drafting the Engagement Letter and Agency Agreement
- drafting the Subscription Agreement
- the due diligence process such as preparing the *Due Diligence Checklist*, making sure all items on the checklist are received from the issuer, assembling the *Due Diligence Binder*, participating in the *Due Diligence Question Session*, and preparing a *Due Diligence Report* for the EMD
- receiving the subscription proceeds in trust
- reviewing and preparing legal opinions and other ancillary closing documents
- releasing the subscription proceeds to the issuer/issuer's counsel on closing, net of amounts due to the EMD and EMD's counsel

THE ROLE OF COUNSEL FOR THE ISSUER ON CLOSING

The role of counsel for the issuer is to ensure that the interests of the issuer are represented. Counsel for the issuer is usually involved in:

- review of the Engagement Letter and Agency Agreement
- review of the Subscription Agreement
- the due diligence process such as participating in the *Due Diligence Question Session* and assisting with the issuer's response to due diligence questions
- preparing ancillary closing documents including a legal opinion concerning certain legal matters pertaining the issuer and the validity of the issuance of the securities in accordance with applicable securities laws

CLOSING DOCUMENTS

The principal documents to close a financial transaction typically include:

- Subscription Agreements
- Agency Agreement
- share certificates for each subscriber
- broker warrant certificates in the name of the EMD
- legal opinions of the issuer's and EMD's counsel
- cheques payable to the issuer for settlement of the transaction (net of the EMD's entitlement (success fees and expenses) together with receipts)
- corporate documents of the issuer, namely: articles of incorporation, certified board resolutions approving the financing, certificates of incumbency showing officers and directors of the issuer
- filings to be made with the securities commissions post-closing

LEGAL OPINION

Legal opinion is almost always obtained in any sophisticated financing transaction. While the subject of legal opinions and what they should include is a topic of extensive publication, at a minimum, the issuer's counsel should opine that:

- the issuer is validly incorporated and organized and that the minute books are up-to-date
- the transaction documents such as the *Subscription Agreement*, *Agency Agreement*, and broker warrant certificates have been validly authorized by the corporation
- the securities issued in connection with the financing transaction have been validly issued

Additionally, the issuer's counsel should opine on:

- the number of issued and outstanding securities based on a review of the minute book (for closely held issues (shares where related parties own a significant interest))
- lawsuits involving the issuer
- the issuer's legal title to property (e.g. the real property, lands or mining and natural resource claims, etc. in more sophisticated transactions)

Counsel for the EMD may, but not always, be asked for a legal opinion which would have them opine on:

- due valid authorization
- due execution
- validity of the EMD's registration under securities law (so as to enable the payment of the success fees and issuance of broker warrants to the EMD)

SETTLEMENT ON CLOSING

Counsel for the EMD will usually receive all proceeds according to the instructions set out in the *Subscription Agreements* and hold those funds in trust pending completion of the closing. As established in NI 31-103, all client assets must be held in trust, separate from the assets of the EMD.

Standard practice is for the EMD to collect and forward cheques or bank drafts made out in trust to the EMD's counsel. This settlement process is a critical back-office function of the EMD. Once all items on the closing agenda have been delivered and the counsel of both parties have agreed that the transaction is ready to close, the EMD will instruct its counsel in writing to disburse the funds to the issuer/issuer's counsel, net of the EMD's success fees and expenses. As a final step, the EMD's counsel will retain its legal fees and release the balance in its trust account to the issuer/issuer's counsel.

UNIT SUMMARY

Congratulations, you have reached the end of Unit 5: The Private Placement Process.

In this unit you covered:

- Lesson 1: The Engagement Letter
- Lesson 2: Agency Agreement
- Lesson 3: Subscription and Agency Agreements
- Lesson 4: Closing and Financial Transaction

Now that you have completed these lessons, you are ready to assess your knowledge with a 10-question quiz. To start the quiz, return to the IFSE Landing Page and click on the Unit 5 Quiz button.

UNIT 6

THE STRUCTURES OF ISSUERS

INTRODUCTION

In this unit you will learn about how issuers in the capital market are structured.

This unit takes approximately 2 hours and 15 minutes to complete.

Lessons in this unit:

1. Corporations
2. Limited Partnerships
3. Trusts
4. Funds
5. Asset-Backed Securities

Corporations 1

CONTENT AREAS

Corporations

Types of Securities Issued by Corporations

Equities

Tax Considerations

INTRODUCTION

In this lesson, you will learn about issuers that are structured as corporations.

This lesson takes approximately 30 minutes to complete.

LEARNING OBJECTIVES

At the end of this lesson, you will be able to:

1 | Define what a corporation is and discuss the characteristics of corporations.

2 | Describe the documents for a corporation.

3 | Discuss the stakeholders in a corporation.

4 | Discuss the elements of shareholder meetings.

5 | Explain shareholder rights and protections.

6 | Explain the types of securities offered by corporations and different share classes.

7 | Understand the tax considerations of corporations.

CORPORATIONS

A corporation is a separate legal entity that is owned by the shareholders. The corporation is separate from the shareholders, it can hold property in its own name, it can sue and be sued, and it is taxed in its own right.

In Canada, the federal government and the provinces have legislation governing corporations. The Canada Business Corporations Act (CBCA) creates the framework for business corporations formed federally, whereas provincial statutes, such as the Business Corporations Act (Ontario) (OBCA), govern business corporations formed provincially.

Since corporations are governed by federal and provincial legislation, there is more predictability with the issuers in comparison to issuers structured under limited partnerships or trusts.

DEFINING CHARACTERISTICS OF A CORPORATION

A business corporation has the following defining characteristics:

- separate legal entity
- limited liability of shareholders
- perpetual existence
- centralized management
- transferability of shares

	Corporation

Separate Legal Entity	• considered a "person" in law
	• can do many of the things a natural person can do under Canadian law including:
	  ◦ enter into contracts
	  ◦ go into debt
	  ◦ own property
	  ◦ be held responsible for crimes, negligence, etc.
	• separate legal entity, separate from its owners (the shareholders)

Limited Liability of Shareholders	• the shareholders have limited liability:
	  ◦ if the corporation is sued, it is the corporate entity being sued, not the shareholders
	  ◦ if the corporation fails, the creditors cannot recover the amounts owed from the shareholders
	• the liability of a shareholder is limited to the amount they invested

Perpetual Existence	• continues to exist beyond the natural life of:
	  ◦ those who incorporate it
	  ◦ officers
	  ◦ directors
	  ◦ shareholders
	  ◦ employees
	• provides predictability since it is not impacted by death, incapacity, or departure of any natural persons

Centralized Management	• management of the corporation is centralized in the board of directors • corporate statutes give authority to the directors to delegate responsibilities to officers • control of the corporation lies with the voting shareholders who elect the board of directors • provides transparency and predictability
Transferability of Shares	• shares can be transferred from one investor to another

CORPORATION DOCUMENTS

Corporations are governed by the corporate documents including:

- articles
- by-laws
- unanimous shareholder agreements

ARTICLES

The foundation of a corporation is established in its articles (also referred to as "memorandum of association" or "letters patent") which include:

- **Articles of incorporation:** forms the corporation, designates its name (including a number name if no formal name is adopted), sets the number of directors, installs and empowers the director(s), establishes the classes and series of shares and the rights attaching to those shares, and designates the registered office.
- **Articles of amalgamation:** effects an amalgamation of the corporation with one or more other corporations, forming a new corporation as successor.
- **Articles of arrangement:** effects an arrangement including transactions similar to a transfer of shares or assets of the corporation.

A review of the articles of a corporation is a core element of due diligence and since the articles are a matter of public record, the review can be done through a corporate search.

BY-LAWS

The by-laws of the corporation establish the codes enacted by a corporation to govern its operation and management. Typical by-law provisions include:

- **Directors:** terms of office, election and removal, committees, meetings, remuneration, indemnification
- **Officers:** appointment, remuneration, removal, and description
- **Shareholders:** annual meetings, special meetings, notice requirements and waiver of notice, voting, proxies, quorum, adjournment, resolutions in writing in lieu of meetings, information available (or not available) to shareholders
- **Shares:** issuance, share certificates, registrar and transfer agent, share register and transfer register
- **Other:** dividends, signing authority and execution of documents, financial year, banking, borrowing, cheques, drafts and notes, divisions within the corporation

Unlike a corporation's articles, the by-laws are typically not public. As such, by-laws must be requested for review for due diligence.

UNANIMOUS SHAREHOLDER AGREEMENTS

A unanimous shareholder agreement (USA) is an agreement among all of the shareholders of a corporation. Under such an agreement, the collective shareholders can alter the powers of the board and can make other arrangements for conducting the business of the corporation. Therefore, it is important to determine whether a USA exists for the corporation during due diligence and if one exists, the USA must be reviewed to determine the impact on the company.

THE CORPORATION'S STAKEHOLDERS

The roles of the stakeholders in the corporation are established in the Corporate Charter, Articles of Incorporation, By-Laws and Shareholder's Agreement. The stakeholders in the corporation include the:

- Board of Directors
- Officers
- Shareholders
- Management

BOARD OF DIRECTORS

The Board of Directors (the Board) is the body of elected or appointed members who are charged with the responsibility of overseeing the management of the corporation. The board of directors are usually elected at the annual meetings of the shareholders.

Where a corporation is an issuer that raises capital in the financial markets, it must have at least three directors. Generally, all material matters must be approved by the board of directors. For example, the board of directors of a corporation will typically approve:

- the issuance of securities
- the declaration of dividends
- the appointment of officers
- the approval of material contracts and material transactions
- the wind-up and dissolution of the corporation

Directors owe a fiduciary duty to the stakeholders in the corporation. If a director fails to discharge his or her duty to the corporation, he or she can be liable for damages attributable to the failure of the corporation.

OFFICERS

The board of directors appoints the officers of the company including the:

- Chief Executive Officer
- President
- Secretary
- Treasurer
- Other senior officers including the: Chief Financial Officer, Chief Operations Officer, Chief Information Officer
- Vice President(s) and Executive Vice President(s)

The officers of a corporation are employees of the company. In some circumstances, certain officers of the corporation, for example the Chief Executive Officer or President, may also be a director on the board of directors. The officers manage the business and affairs of the corporation.

SHAREHOLDERS

The shareholders are the owners of the corporation and those with voting shares vote to elect the members of the board of directors. A majority shareholder is one who holds sufficient shares and votes to control the election of the board.

MANAGEMENT

The strength of a corporation and its business will depend on the people who manage the business. Therefore, the due diligence of an issuer must consider the capabilities of its management team.

MANAGEMENT FEE STRUCTURE

In the case of a corporation, there are three levels of fee entities you should consider:

- board fees
- executive compensation
- external management and other fees

All of these fee arrangements need to be reviewed and understood in connection with an investment in shares of a corporation.

SHAREHOLDER MEETINGS

Corporations are required to hold annual meetings of voting shareholders of the corporation. At each annual meeting, the agenda must include the:

- election of directors
- appointment of auditors
- presentation of the annual financial statements of the corporation

These items require approval by a majority of the votes cast and agenda items passed by the shareholders are called shareholder resolutions.

Any business other than annual general business to be brought before the shareholders for a vote constitutes "special business". Special business must be approved by a "special resolution", which requires a "super majority" of 66 2/3% of the votes cast.

Corporate statutes impose extensive requirements for holding and conducting shareholder meetings. There are also rules empowering shareholders to request meetings to bring forward matters important to shareholders. These rules safeguard the fundamental right of shareholders to vote. There are no parallel statutory requirements for partnerships, limited partnerships, or trusts. In those cases, any entitlement to vote will be a matter of agreement among the parties. This further demonstrates the relative predictability of corporations as a structure for issuers.

SHAREHOLDER RIGHTS AND PROTECTIONS

Shareholders of corporations have statutory rights and protections whereby certain fundamental actions cannot be taken by the corporation without the approval of the shareholders including:

- amendments to a corporation's articles and by-laws
- amalgamation of the corporation with one or more other corporations
- a plan of arrangement
- voluntary wind-up of the corporation
- sale, lease, or exchange of all or substantially all of the assets of the corporation

In the event of an abuse, there are special remedies available to shareholders under legislation as follows:

- **Oppression Remedy:** The oppression remedy is a judicial means to rectify a wrong suffered by shareholders
- **Derivative Action:** A derivative action enables a shareholder to cause the corporation to follow its direction when the directors of the corporation will not
- **Votes on Proposed Changes to a Class or Series of Shares:** If any changes to a class or series of shares are proposed, such as a change in the number of authorized shares, reclassification, new restrictions or conditions, the holders of that class have the right to vote "separately as a class" on the proposed changes. The holders of any class of shares, including non-voting shares, are entitled to vote in order to protect themselves where changes are proposed to the class or series of shares they own. This fundamental statutory protection of shareholders ensures that the rights represented by the shares they hold are not eroded or diminished in any way without an opportunity to prevent it.

There are no similar statutory protections for investors in limited partnerships or trusts. In those cases, any such protections would be a matter of contract and if there are no contractual protections, investors would be left to resort to civil action.

TYPES OF SECURITIES ISSUED BY CORPORATIONS

Issuers can issue many different types of securities in order to raise capital including:

- equities: common and preferred shares
- fixed income: bonds, debentures, commercial paper, promissory notes

EQUITIES

Equities are shares issued by a corporation to the shareholders of the company. The shares represent ownership in the corporation, also known as share capital. The share capital of the corporation includes the common and preferred shares issued and outstanding.

COMMON SHARES

Common shares represent units of ownership in a company and returns are derived from the appreciation or depreciation in the share's value which is driven by the company's profitability. The typical features of common shares are:

- **Voting:** unless otherwise specified, common shares entitle the holder to one vote per share and carry a right to receive notice of and to attend and vote at all meetings of shareholders.
- **Dividends**: there are no contractual obligations for a company to pay dividends to common shareholders, although dividends are often paid on the common shares of highly profitable companies.
- **Participation on dissolution:** common shareholders may participate in the remaining property of the corporation upon dissolution, after the holders of bonds, debentures, and preferred shares.

OTHER CLASSES OF SHARES

Other classes of shares issued by a corporation would include:

- Preferred shares
- Special shares
- Class A shares, Class B shares, etc.
- Multiple voting shares
- Subordinate voting shares

Classes of shares can vary greatly and can be designed to achieve very specific objectives. The rights and privileges attached to any class of shares are described in the articles of the corporation.

IMPORTANCE OF SHARE CLASS AND RIGHTS

It is important to understand the bundle of rights attributed to any class of shares relative to other factors including:

- other classes of shares issued by a corporation
- whether the corporation is authorized to issue other classes of shares

EXAMPLE

Avatronics Inc. has authorized only one class of shares, common shares. The provisions in the articles of the corporation will contain the following:

"The Corporation is authorized to issue an unlimited number of common shares."

Where the corporation has common shares and no other class of shares, there is no requirement to state the specific rights of the holders of those shares. The holders of common shares in these circumstances will have the three rights: voting, dividends, and participation on dissolution.

EXAMPLE

Wernerwave Corp. has authorized two classes of shares, common shares and preferred shares. Therefore, it is necessary for the corporation to describe the rights for the two classes of shares in its articles of the corporation. With respect to the common shares, the articles would typically specify that the common shares are subordinate to the preferred shares in respect of dividends and participation upon liquidation, dissolution, or wind-up of the corporation.

When a corporation has issued multiple classes of shares or is authorized to issue multiple classes of shares, you must know the rights applicable to all classes of shares in order to assess the shares in the offering.

DIVIDEND CONSIDERATIONS

Corporate legislation prevents a corporation from making certain payments, such as dividend payments, if making the payment would result in the corporation being unable to meet its obligations as they become due. Therefore, in certain circumstances where a company is in distress, a corporation may not pay dividends even where they are provided for in the corporation's articles. Therefore, in assessing a class of shares, you must consider whether the corporation is able to make dividend payments as provided for in the articles and if so, whether it is reasonable to assume that it will continue to be able to pay dividends.

TAX CONSIDERATIONS

The tax considerations of any investment should be determined in consultation with a professional tax adviser. For information purposes, the general tax considerations in relation to corporations are outlined below.

INCOME OF THE CORPORATION

A corporation is a separate and distinct entity and, like a natural person, a corporation is a taxpayer. Corporations generally pay a flat tax rate based on the type of income and the type of corporation, as compared to the graduated marginal tax rates which are applied to individuals based on income thresholds. Income earned by a corporation is taxed to the corporation. The corporation then pays dividends to its shareholders out of the net "after-tax" income. The shareholders are taxed on the dividends they earn on their shares.

In absence of special measures, the same income would be taxed twice:

1. the corporation is taxed; and
2. the shareholder is taxed.

In order to avoid double taxation on the same income, the Income Tax Act of Canada has systems in place, including the "imputation system". How the dividends are treated from a tax perspective depends on:

- **the type of corporation:** public corporation, private corporation, Canadian-controlled private corporation
- **the recipient of the dividend:** individual or corporation

TAXATION OF DIVIDENDS

Dividends paid to individual shareholders are treated under the imputation system. The objective of the imputation system is to treat the dividend income in such a way so that the dividends are only taxed once. In order to achieve this, a calculation is performed to treat the dividend income as follows:

1. The actual amount of the dividend paid to the shareholder is "grossed up" by the tax rate of the corporation

Formula: Gross-Up Dividend

$A + (A \times B) = C$

Where:

A = the actual amount of the dividend paid to the shareholder

B = the corporation's tax rate

C = the grossed up amount of dividends

2. The shareholder is taxed on the grossed up amount of the dividend (notionally, the shareholder's portion of the gross "pre-tax" income corresponding to the dividend)
3. The dividend tax credit is deducted from the shareholder's tax payable (notionally, the amount of the tax the corporation paid as a "pre-payment" on behalf of the shareholder)

From a tax perspective, dividends from Canadian corporations are categorized into 2 categories:

- **Eligible dividends:** paid by large corporations that are typically public companies
- **Other dividends:** paid by small, private corporations

Different tax rates and rates for the gross-up and the dividend tax credit apply depending on whether the dividends are eligible dividends versus other dividends.

For dividends paid to a Canadian corporation, the dividends are not subject to a gross-up and dividend tax credit. Instead, the dividends will generally be deductible in computing the corporate shareholder's taxable income to avoid double tax. Private corporations generally are subject to a 33 1/3% refundable tax on dividends received. This refundable tax generally will be refunded to a corporate shareholder at the rate of $1 for every $3 of taxable dividends paid while it is a private corporation.

CAPITAL GAINS

A capital gain is the profit on the disposition of property that is not otherwise included in income. Financial instruments such as shares, bonds, and mutual funds are examples of property that are subject to capital gains if disposition results in a profit.

The amount of the capital gain is the difference between the proceeds of disposition and the total of:

- the adjusted cost base of the asset; and
- the expenses incurred to dispose of the asset.

Capital gains are not taxed in full. The portion of a capital gain which must be included in the taxpayer's income is the "taxable capital gain". In order to determine the taxable capital gain, the capital gain is multiplied by the "inclusion rate". The calculation is performed as follows:

Formula: Taxable Capital Gain

A × B = C

Where:

A = the capital gain

B = the inclusion rate (currently 50%)

C = the taxable capital gain

CAPITAL LOSSES

A capital loss is the shortfall from the disposition of property where:

- The adjusted cost base + expenses exceed the proceeds from disposition

The inclusion rate for a capital loss is the same as the rate for capital gains (currently 50%). The application of the inclusion rate determines the allowable capital loss for income tax purposes. An allowable capital loss is used to reduce taxable capital gains.

To be clear, capital losses cannot be deducted from income. Capital losses can only be offset against capital gains. Where taxable capital gains are claimed in the same year as an allowable capital loss, the allowable capital loss must first be used to reduce any taxable capital gains in the same year. If capital losses exceed capital gains for a given tax year, the capital loss may be carried back and deducted in any of the three preceding years or carried forward and deducted in any following years against capital gains realized in those years.

CAPITAL GAINS DEDUCTION

Individuals are entitled to claim a lifetime exemption of taxable capital gains to shelter gains realized on shares of certain types of corporations such as Canadian-controlled private corporations, family farm corporations, and family fishing corporations. The exemption does not apply to the disposition of securities of public corporations, including common shares, bonds, or prospectus mutual funds. There are detailed requirements pertaining to the shares and the shareholder which must be satisfied in order to qualify for the capital gains exemption. Determination of whether an investor qualifies for the capital gains exemption should be made in consultation with a professional tax advisor.

RRSP AND TFSA ELIGIBILITY

Many investors will want to use funds in their self-directed RRSP or TSFA to invest in shares of corporations, but not all shares are qualified investments for trusts governed by RRSPs and TSFAs. The trustee of the RRSP or TFSA will generally require a lawyer's opinion regarding RRSP or TFSA eligibility if the securities are not those of a public company. The annuitant or holder of an RRSP or TFSA can incur penalties if their RRSP or TFSA acquires property which is not a qualified investment. RRSP and TFSA eligibility should be determined in consultation with a professional tax adviser.

Limited Partnerships

2

CONTENT AREAS

INTRODUCTION

In this lesson, you will learn about issuers that are structured as limited partnerships.

This lesson takes approximately 30 minutes to complete.

LEARNING OBJECTIVES

At the end of this lesson, you will be able to:

1 | Define limited partnerships and explain how they work.

2 | Discuss the different partners in a limited partnership and their roles and rights.

3 | Describe limited partnership declarations and agreements.

4 | Discuss investing in limited partnerships.

5 | Understand the tax considerations of limited partnerships.

WHAT IS PARTNERSHIP?

A partnership is an unincorporated business owned by two or more partners. Partnership agreements can be structured as:

- General Partnerships
- Limited Partnerships

Under a general partnership, all the partners are "general partners" who have the same rights and obligations and they are all legally liable for the debts, losses, damages, or obligations of the partnership (unlimited liability). Each partner is an agent of the partnership and of the other partners, and therefore the actions of one partner binds each of the other partners. Each partner is jointly and severally liable with all of the other partners.

A limited partnership establishes "limited partners", in addition to the "general partners", who do not have obligations or liabilities beyond the amounts they contributed to the partnership. The "limited partners" are not permitted to be actively involved in the business or affairs of the partnership and if they do engage in such activities, they lose their "limited liability" benefits. From an investment perspective, most issuers will be structured as a limited partnership and it would be rare to issue securities under a general partnership since investors would want limited liability.

Regardless of the partnership structure, the partnership is not a separate legal entity like a corporation. Limited partnerships also do not benefit from an extensive code of rules established under governing statute and they do not benefit from the protections that corporations do. All considerations relating to rights and protections are a matter of contract between the parties. Contracts will vary from case to case, so due diligence will be required in order to fully understand the parameters of a limited partnership. This lack of uniformity makes issuers structured as limited partnerships less predictable than corporations.

PARTNERS IN A LIMITED PARTNERSHIP

A partnership must have at least two partners in order to exist as a partnership. A limited partnership must have:

- at least one general partner; and
- at least one limited partner.

GENERAL PARTNER

General partners are active, they run the business of their limited partnership, and they have full responsibility for the day-to-day affairs of the limited partnership.

If you were to compare a limited partnership and a corporation, you could draw a loose parallel between the role of the board of directors of a corporation and the role of the general partner of a limited partnership—both have ultimate authority for their respective business and they can be held liable in respect of their role and obligations. The liability of a corporation does not flow through to the owners of the corporation (i.e., its shareholders). For this reason, it is a common practice to have a corporation as the general partner of a limited partnership.

LIMITED PARTNER

Limited partners contribute capital to the limited partnership and share in its profits and losses, but remain as passive investors. Similar to the shareholders of a corporation, the limited partners are the ultimate owners of the limited partnership but their liability is limited to the amount they contribute to the limited partnership.

RIGHTS OF LIMITED PARTNERS

The Limited Partner Act (Ontario) gives certain specific rights to limited partners. For example, a limited partner has the same right as a general partner to:

- inspect and make copies of or take extracts from the limited partnership's books at all times
- be given, on demand, true and full information concerning all matters affecting the limited partnership and to be given a complete and formal account of its affairs
- obtain dissolution of the limited partnership by court order

Additionally, a limited partner may:

- examine the state and progress of the limited partnership's business and advise as to its management
- act as a contractor for, or an agent or employee of, the limited partnership or of a general partner
- act as a surety for the limited partnership (a surety agrees to be primarily liable for the conduct, obligation, or performance of the limited partnership)

LOSS OF LIMITED LIABILITY

Limited liability can be lost when a limited partner takes part in the control of the business. The more active a limited partner becomes in the business of a limited partnership, the greater the risk of losing limited liability. The risk of loss of limited liability with respect to an investor is minimal since the risk that the limited partner (investor) would become involved in the control of the business would most commonly be unlikely.

CONSIDERATIONS FOR LIMITED PARTNERS

Some considerations for limited partners are summarized in the table below.

Considerations for Limited Partners	
Consideration	**Details**

Entitlement to profit and return of contributions	• A limited partner has the right to a share of the limited partnership's profits or other compensation:
	  ◦ income
	  ◦ return of its contribution to the limited partnership

Liability for returns of contributions	• If all or part of a limited partner's contribution is returned:
	  ◦ the limited partner is liable for any liabilities of the limited partnership to creditors, where the claim arose before the return of the contribution (there is no liability if the claim of the creditors arose after the contribution was returned)
	• If the limited partnership has been dissolved:
	  ◦ the limited partner continues to be liable to those creditors for the return of the contribution where the claim arose before the return of the contribution
	• Regardless, the amount of the limited partner's liability cannot exceed the amount previously returned plus interest

Assignment	• A limited partner may assign their interest in a limited partnership • The assignee of a limited partnership interest becomes a substituted limited partner for the assigning limited partner (when accepted by all of the limited partners)

DECLARATIONS

A partnership must declare itself to be a limited partnership by filing *a Declaration of Limited Partnership* in accordance with its governing statute, such as the Limited Partnerships Act (Ontario).

The declaration includes basic information including:

- the firm name
- nature of the business
- contact information for each general partner
- power of attorney contact details (in the case of an extra-provincial limited partnership)

The *Declaration of Limited Partnership* expires every five years and must be renewed if the limited partnership is to continue. A new declaration must be filed when there is a change in the name of the limited partnership.

A *Declaration of Change* must be filed where:

- there are other changes to the limited partnership (other than a name change)
- the limited partnership is dissolved
- an extra-provincial limited partnership is withdrawn

RECORD OF LIMITED PARTNERS

The *Declaration of Limited Partnership* does not include the name and address of the limited partners. Under legislation, the general partners are required to maintain a current record of the limited partners, the *Record of Limited Partners*, at the limited partnership's principal place of business. The *Record of Limited Partners* must state the amount each limited partner contributed to the limited partnership.

PUBLIC ACCESS

Limited partnerships are subject to certain public access requirements. For example, under the Limited Partnerships Act (Ontario), any person who has a business relationship with a limited partnership may inspect documents pertaining to the limited partnership during normal business hours including the:

- *Declaration of Limited Partnership*
- *Declaration of Change*
- *Record of Limited Partners*
- any court order of compliance
- a copy of the power of attorney filed with the registrar (in the case of extra-provincial limited partnerships)

The documents available for public access will be useful to third parties dealing with the limited partnership, such as creditors.

THE LIMITED PARTNERSHIP AGREEMENT

There is no statutory requirement that a limited partnership be governed by a written *Limited Partnership Agreement*. However, it is prudent practice to prepare a written agreement to establish the parameters of the limited partnership including the rights and protections of the limited partners. From the perspective of an offering of securities, you must review the *Limited Partnership Agreement* as a matter of your due diligence obligations.

The components of a *Limited Partnership Agreement* include:

Limited Partnership Agreement	
Component	**Details**
General Information	• business of the limited partnership
General Partner	• powers • standard of care (normally its obligation to discharge its duties honestly, in good faith, and in the best interests of the limited partners) • interest in the net income and assets • liability (typically mirrors the statutory provision of unlimited liability of the general partner for the debts, liabilities, and obligations of the limited partnership) • circumstances in which the general partner may be removed (usually restricted to extreme circumstances, such as fraud or misconduct)

Limited Partnership Agreement	
Component	**Details**
Limited Partners	• liability of limited partners (typically mirrors the statutory provision for limited liability and the circumstances in which a limited partner may lose the benefit of limited liability) • accounting and reporting to the limited partners (such as financial statements and tax slips) • Record of Limited Partners
Limited Partnership Units (LPUs)	• ownership (who may own units, restrictions) • rights and obligations of unit holders • amount of capital contribution per unit • manner of transferring units, including any restrictions on the transfer of units
Structure and Operation of the Limited Partnership	• manner of allocating the limited partnership's income or loss among the limited partners (usually pro rata to the number of units held) • manner of calling and holding meetings of partners • manner of amendment of the limited partnership agreement • limited recourse financing (debt) • maintenance of books and records • term of the limited partnership
Dissolution	• settling accounts after the dissolution of a limited partnership (the partners are free to decide how they want the assets of the limited partnership to be distributed once the creditors have been paid)

WHAT IS LIMITED PARTNERSHIP INTEREST?

Interest in a limited partnership describes the bundle of rights and obligations of a limited partner in a limited partnership including:

- the right to participate in the profits and losses of the limited partnership
- voting rights (where provided for in the *Limited Partnership Agreement*)

For the purposes of securities legislation in Canada, an interest in a limited partnership is a security. The definition of "security" in the Securities Act (Ontario) is "any document constituting evidence of title to or interest in the capital, assets, property, profits, earnings or royalties of any person or company".

LIMITED PARTNERSHIP UNITS (LPUS)

Most limited partnerships that offer interest in the limited partnership to investors issue "units". Issuing units of a limited partnership to investors is similar to issuing shares of a corporation.

Typically, a limited partnership will have a single class of units. Where a limited partnership has multiple classes of units, you will need to learn the essential facts about each class as a matter of your due diligence obligations, similar to multiple classes of shares in a corporation. You will need to consult the *Limited Partnership Agreement* to learn the facts about the limited partnership units.

TAX CONSIDERATIONS

The tax considerations of any investment should be determined in consultation with a professional tax adviser. For information purposes, the general tax considerations in relation to limited partnership units are outlined below.

ALLOCATION OF INCOME AND TAXES

A limited partnership is not a separate legal entity like a corporation. Therefore, the limited partnership does not pay taxes on its income like a corporation does. Rather, both the income of the partnership and the tax owed on that income is allocated to the limited partners (i.e. the unit holders).

The unit holders receive the income generated by the limited partnership in its original form and then must report the income in their tax filings as originally allocated to them, for example as:

- interest
- dividends
- capital gains

The unit holders are required to include the income allocated to them in their tax filings regardless if the income was distributed to them in cash or it was retained by the partnership for use in the business.

Unlike investors of other securities (for example mutual funds or exchange-traded funds), the losses incurred by a limited partnership are also allocated to the limited partners. These capital losses can also be claimed by the limited partners (i.e. unit holders) in their tax filings subject to normal conditions. For example, capital losses can only be offset against taxable capital gains; they cannot be deducted from income.

AT-RISK RULES

The at-risk rules in the Income Tax Act (Canada) limit the amount of a capital loss that a limited partner can claim to the amount of the limited partner's at-risk amount. Therefore, a limited partner's loss cannot exceed the amount that the limited partner stands to lose and the adjusted cost base (ACB) of the investment cannot be reduced below zero dollars.

EXAMPLE

Adam invests $30,000 in the ResGem Limited Partnership and earns $5,000 in income from the partnership, for an adjusted cost base (ACB) of $35,000 ($30,000 + $5,000). The partnership loses $1,000,000 of which $45,000 is allocated to Adam. However, the maximum loss that Adam can claim is $35,000, the at-risk amount of his investment. After Adam claims the losses, the ACB of Adam's investment is $0 ($35,000 – $35,000).

Losses in the example above of $10,000 could not be claimed since the at-risk rules prevent the ACB of an investment to be reduced below zero dollars.

A limited partner's share of any loss denied as a consequence of the application of the at-risk rules is considered to be a limited partnership loss in respect of the limited partnership for the year. The limited partner may deduct the limited partnership loss in future years, provided certain conditions are satisfied.

FLOW-THROUGH TAX TREATMENT

Unit holders can further benefit from a tax perspective where the business of the limited partnership is one which benefits from favorable government policy and tax treatment. For example, in order to encourage investment in the exploration and development of natural resources including oil and gas, mining, and renewable energy, the federal government has designated certain companies as principal-business corporations (PBCs). These PBCs are permitted to issue flow-through shares/units which confer substantial tax benefits to their initial investors (unit holders). The companies flow-through or "renounce" to the unit holders, the expenses which they would otherwise be entitled to. In turn, the unit holders deduct the expenses from their other sources of income, thereby reducing their income taxes payable.

EXAMPLE

Jim subscribes for flow-through shares of a resource company in the amount of $100,000. The company uses the subscription proceeds on exploration and development expenses amounting to $100,000 and renounces the expenses to Jim. Jim deducts the renounced expenses of $100,000 as exploration and development expenses in computing his taxable income. Suppose Jim pays tax at a marginal rate of 46%. The tax saving is $46,000 or ($100,000 × 46%).

RENOUNCEABLE EXPENSES

A PBC may renounce the following types of expenses to unit holders:

- Canadian exploration expense (CEE)
- Canadian development expense (CDE)

Overhead expenses which are included in CEE or CDE may not be renounced to unit holders.

When CEE and CDE are renounced to unit holders, they are added to the unit holder's respective cumulative CEE pool and cumulative CDE pool. The difference between the two pools lies in the percentage of the annual deduction. A taxpayer may deduct up to 100% of the balance in his or her cumulative CEE pool in a year. In the case of the cumulative CDE pool, the maximum percentage deductible in a year is 30%. Any balance not deducted may be carried forward indefinitely and deducted in future years.

INVESTING IN FLOW-THROUGH SHARES

Investors may invest in flow-through shares in two different ways:

- directly by purchasing the shares from a PBC
- indirectly by purchasing units in a limited partnership that purchases flow-through shares from a number of PBCs

Investing directly in flow-through shares of a PBC exposes the investor to the risks inherent in investing in a single issuer in a cyclical industry. Therefore, most individuals invest in flow-through shares indirectly by purchasing units of a limited partnership. A flow-through limited partnership is a professionally managed portfolio which pools the money of many investors and invests in a diversified portfolio of flow-through shares.

Some flow-through limited partnerships are publicly distributed whereas others are distributed by way of a private placement, usually under the offering memorandum exemption. The manager of a flow-through limited partnership is usually entitled to a management fee which may be expressed as an annual percentage of the net asset value of the limited partnership. The manager may also be entitled to a performance bonus which may be expressed as a percentage of the amount by which the cumulative performance of the limited partnership throughout its term exceeds a specified threshold.

TAX-EXEMPT INVESTORS

The structure of limited partnerships is particularly beneficial to tax-exempt investors such as pension funds. Suppose a pension fund invests in a company. Although the pension fund is a tax-exempt entity, it pays tax indirectly because the company pays corporate tax before distributing earnings to shareholders as dividends. However, there is no entity level taxed on income for a limited partnership. The pension fund's share of the limited partnership's pre-tax profits is allocated to the pension fund. Since the pension fund is exempt from paying taxes, the pension fund avoids tax on the profits altogether.

FORM T5013 PARTNERSHIP INFORMATION RETURN

Although limited partnerships generally are not subject to tax, they must file Form T5013 (Partnership Information Return) with the CRA for each fiscal period and at other times during the fiscal period where certain conditions are met. Form T5013 (Partnership Information Return) and the related schedules essentially provide the CRA with information about the limited partnership's income or loss and the share of income or loss allocated to each limited partner.

TAX SLIPS TO LIMITED PARTNERS

Limited partnerships that file Form T5013 (Partnership Information Return) with the CRA must also issue tax slips to its limited partners as summarized in the table below.

Tax Slips	
Form T5013 Statement of Partnership Income	Where the limited partnership is: • NOT a tax shelter; or • did NOT invest in flow-through shares of a principal-business corporation (PBC) and Canadian exploration expense (CEE) or Canadian development expense (CDE) is NOT applicable/NOT renounced.

Form T5013A Statement of Partnership Income for Tax Shelters and Renounced Resource Expenses	Where the limited partnership:
	• is a tax shelter; or
	• invested in flow-through shares of a PBC that:
	  ◦ incurred CEE or CDE; and
	  ◦ renounced the expense to the limited partnership.

The limited partners use the information from their T5013 or T5013A tax slip to report their share of the limited partnership's income or loss on their tax return.

ADJUSTED COST BASE (ACB) OF A LIMITED PARTNERSHIP UNIT

When a limited partner sells their limited partnership units, the capital gain or loss must be considered for tax purposes. The amount of the capital gain is the difference between the proceeds of disposition and the total of:

- the adjusted cost base (ACB) of the units; and
- the expenses incurred to dispose of the units.

In order to determine the adjusted cost base (ACB) of the limited partnership units, a calculation is performed as follows:

Formula: Adjusted-Cost Base

$(A + B) - (C + D) = E$

Where:

A = the subscription price paid for the unit

B = income allocated to the limited partner

C = losses, investment tax credits, and resource deductions allocated to the limited partner

D = cash distributions made to the limited partner

E = Adjusted-Cost Base of the units

If the ACB is less than zero (for instance if the limited partnership makes a large distribution), the negative amount of the ACB is deemed to be a capital gain.

Trusts 3

CONTENT AREAS

INTRODUCTION

In this lesson, you will learn about issuers that are structured as trusts.

This lesson takes approximately 20 minutes to complete.

LEARNING OBJECTIVES

At the end of this lesson, you will be able to:

1 | Define trusts and explain how they work.

2 | Describe the stakeholders in a trust.

3 | Explain the duties of the trustee.

4 | Describe the components of the *Declaration of Trust*.

5 | Discuss the advantages of a trust as an investment structure.

6 | Describe a mutual fund trust as an example of a business trust.

7 | Discuss the liability of beneficiaries of a trust.

8 | Understand the tax considerations of trusts.

WHAT IS A BUSINESS TRUST?

A trust is a relationship in which one person (the trustee) holds property for the benefit of another person or persons (each, a beneficiary). There is a wide variety of trusts in common use. From an investment perspective, issuers are structured as business trusts.

A business trust is:

> *"a trust established for the purpose of conducting a business, directly or indirectly, and confers upon the trustee broad discretionary authority to manage the business for the benefit of the beneficiaries"*

Trusts are created and governed by contract. While there is legislation governing trustees as well as loan and trust corporations (i.e. corporations that offer trust services to the public, take deposits, and lend) there is no legislation in Canada for trusts. The details of the trust are determined by the contracting parties in the agreement governing the trust.

CREATION OF A TRUST

The three certainties that establish a trust are:

- **Certainty of intention:** the settlor must intend to create a trust
- **Certainty of subject matter:** the specific trust property must be ascertainable
- **Certainty of objects**: the beneficiaries must be ascertainable

The *Declaration of Trust* or *Trust Agreement* between the trustee and the settlor establishes the trust and describes the "terms of the trust": the specific contractual requirements for carrying out the purpose of the trust.

STAKEHOLDERS

The stakeholders in a trust include the:

- trustee
- beneficiaries
- manager
- other contracting parties

TRUSTEE

The trustee holds the power and authority for a trust, subject to the terms of the trust. In the context of a business trust, the trustee is the manager of the business for the benefit of the beneficiaries of the trust. The trustee can delegate some or all of its responsibilities to a manager and others by contract. Notwithstanding delegation, a trustee remains legally responsible to the beneficiaries.

Unlike a corporation, a trust is not a separate legal entity. Consequently, a trust does not have the power to hold title to property. The trustee of the trust is the legal person who has the power to hold title to trust property and enter into contracts.

Likewise, there is no limitation of liability for trustees. While trustees are entitled to indemnification in certain circumstances, they may incur substantial liabilities under the *Income Tax Act* (Canada) and they can be held liable to beneficiaries for breaches of trust. A breach of trust occurs if a trustee violates any duty that they owe as trustees to the beneficiaries. One example would be investing in securities that were not a proper investment for the trust. It is important to note that this is not the same as making an underperforming investment choice. Instead, it would cover investments that should never be included in a trust's portfolio, for example currency futures in a real estate investment trust (REIT).

An individual or a corporation can act as trustee. A trust can also have more than one trustee. Where there are multiple trustees, the collective body of trustees is often referred to as a board of trustees.

BENEFICIARIES

The beneficiaries of a trust are those persons who hold the beneficial or equitable interest in the trust property. The trust is administered by the trustee for the benefit of the beneficiaries. In the context of a business trust, the beneficiaries have an interest in the business, similar to the interests of the shareholders of a corporation and the limited partners of a limited partnership. From the perspective of investing, the beneficiaries are the unit holders of the trust.

THE MANAGER AND OTHER CONTRACTING PARTIES

All authority in respect of a trust is vested with the trustee. In the context of a business trust, it is typical for the trustee to delegate general management authority to a management company. Other roles can be delegated separately, such as a portfolio management functions delegated to a registered portfolio manager.

The contracts between the trustee and the contracting parties should be reviewed as a matter of your due diligence obligations.

DUTY OF THE TRUSTEE

The trustee is responsible for managing the business of the trust for the benefit of the beneficiaries. The duties of the trustee are established in the *Declaration of Trust* and can also be referenced in legislation (such as the Trustee Act (Ontario)). The duties of trustees include:

- a duty to prepare a plan for the investment of trust property
- a duty to exercise the care, skill, diligence, and judgment that a prudent investor would exercise in making investments
- a duty to exercise prudence in selecting an agent for delegation of its functions and in monitoring the agent's performance

Under legislation governing trustees, the trustee must consider the following criteria in planning the investment of trust property:

- general economic conditions
- possible effect of inflation or deflation
- expected tax consequences of investment decisions or strategies
- the role that each investment or course of action plays within the overall trust portfolio
- the expected total return from income and the appreciation of capital
- needs for liquidity, regularity of income, and preservation or appreciation of capital
- an asset's special relationship or special value, if any, to the purposes of the trust or to one or more of the beneficiaries

RIGHTS OF BENEFICIARIES

The beneficiaries (unit holders) typically have certain rights which are established in the *Declaration of Trust* including:

- **Right to distributions:** Unit holders typically have a right to participate in distributions (when issued by the trustee) in proportion to the number of units they hold
- **Right to vote:** Unitholders commonly have the right to appoint, elect, and remove trustees and unit holder approval is usually required if the trustee wants to make substantial changes to the trust (e.g. the trustee wants to sell a large portion of its assets or wants to change the *Declaration of Trust*)

The *Declaration of Trust* will often provide the beneficiaries of a business trust with the power to replace the trustee of the trust. Legislation also empowers a beneficiary to apply to the court for an order appointing a new trustee. The ability to remove and change the trustee is a fundamental safeguard for the beneficiaries of a trust.

DECLARATION OF TRUST

The legal relationship between the trustee and the beneficiaries of a trust is governed by the terms of the *Declaration of Trust*. The parties involved in creating a business trust have a relatively free hand in drafting the *Declaration of Trust* and they can therefore vary from one trust to another. However, the *Declaration of Trust* typically incorporates some of the elements that exist in the legislative framework for corporations and limited partnerships.

Typical matters incorporated into a *Declaration of Trust* for a business trust established as an investment fund are summarized in the table below.

Declaration of Trust	
Component	**Details**
Trust	• acceptance of the trust • name of the trust • business of the trust • duration of the trust • fiscal year end • office • termination of the trust • amendments
Trustee	• general powers • standard of care and duties • specific powers • delegation • appointment of manager • removal and replacement of the trustee • the qualifications of a trustee
Manager (often set up in a separate agreement)	• management of the trust • standard of care • representations and warranties of the manager • restrictions on the manager
Units and Unit Holders	• units (number, nature, class, series, restrictions, etc.) • distributions to unit holders • meetings of unit holders • determination of net asset value
Other	• investment objectives, strategies, guidelines, and restrictions • fees, compensation, and expenses of the trustee and manager • liability of the trustee, manager, and unit holders • auditors • miscellaneous provisions

There is no standard form of *Declaration of Trust*. Therefore, you must review the *Declaration of Trust* as a matter of your due diligence obligations.

For the purposes of securities legislation in Canada, a unit of beneficial interest in a trust is a security. The definition of "security" in the Securities Act (Ontario) is "any document constituting evidence of title to or interest in the capital, assets, property, profits, earnings or royalties of any person or company".

ADVANTAGES OF A BUSINESS TRUST

Business trusts have become a popular investment structure, which may be attributable to the advantages of holding assets in business trusts, such as:

- separation of equitable and legal ownership — the existence of a separate "equitable" ownership for the beneficiaries allows for an investor interest in the business legally owned by the trustee and managed for the investors' benefit
- fiduciary duty — subjecting the trustee to a fiduciary duty ensures an alignment of interest between the trustee and the investors and creates a powerful safeguard against abuse
- relative absence of mandatory statutory law — fewer mandatory statutory requirements means the creators of the trust have a relatively free hand to achieve business objectives
- flexibility in design — since the trust is governed by contract, a trust can be shaped precisely as the creators intend
- insolvency protection — trust property is often beyond the reach of creditors of the beneficiaries in insolvency situations, and trust property may be beyond the reach of unsecured creditors of the trustee in the event of insolvency
- advantageous tax planning — trusts can be used as flow-through vehicles for tax purposes and also allow flexible allocation of income and losses

MUTUAL FUND TRUST AS AN EXAMPLE OF A BUSINESS TRUST

One of the more common forms of business trusts are mutual fund trusts. A mutual fund is a professionally managed investment portfolio that pools money from many investors in order to invest collectively in a pool of securities, such as equities, bonds, and money market instruments.

A mutual fund trust is established by an agreement between the trustee and the party establishing the fund (the settlor or "sponsor" of the mutual fund). Investors purchase units in the fund. The unitholders of the mutual fund trust are the beneficiaries.

In the case of a mutual fund trust, several functions are required to be performed by persons who are registered under applicable securities legislation. A registered portfolio manager is required to perform the investment management function and a registered investment fund manager is required to administer the business and affairs of the fund. Therefore, the *Declaration of Trust* will delegate these duties to the portfolio manager and investment fund manager.

For a mutual fund trust, the portfolio manager and investment fund manager assume the critical functions necessary for the operation of the mutual fund trust. The trustee retains ultimate legal responsibility and liability for all the delegated functions and has a duty to monitor the performance of the portfolio manager and investment fund manager.

LIABILITY OF BENEFICIARIES

While the shareholders in corporations and the unit holders of limited partnerships have limited liability, there is no corresponding statutory limitation on liability in the case of the beneficiary of a trust. Liabilities could include those arising from claims of negligence or in respect of taxes.

In 2004, Ontario enacted legislation to create limited liability for the beneficiaries of certain trusts. The Trust Beneficiaries' Liability Act, 2004 (Ontario) provides that the unitholders of a trust are not liable for any act, default, obligation, or liability of the trust or any of its trustees if, when the liability arises, the trust is:

- a reporting issuer under the Securities Act (Ontario)
- governed by Ontario laws

The legislation, however, does not address the liability of beneficiaries of non-public trusts.

TAX CONSIDERATIONS

The tax considerations of any investment should be determined in consultation with a professional tax adviser. For information purposes, the general tax considerations in relation to trust units are outlined below.

ALLOCATION OF INCOME AND TAXES

The Income Tax Act (Canada) treats a trust as a separate taxpayer for income tax purposes. This means that any income earned by the trust, after management fees and expenses, will be taxed in the trust, separate from the beneficiaries. Where the trust distributes income to the beneficiaries, the income is taxed to the beneficiaries.

The Income Tax Act (Canada) contains provisions which permit flow-through tax treatment of income earned by a trust subject to certain conditions. Income that is earned through a trust and then paid to the beneficiaries (i.e. unit holders) is taxed at only one level, to the beneficiaries. Income earned by the trust and retained by the trust is taxed to the trust.

The beneficiaries (unit holders) receive the income generated by the trust in its original form and then must report the income in their tax filings as originally allocated to them, for example as:

- interest
- dividends
- capital gains

SIFT RULES

The trust structure has greater tax efficiency since there is no tax at the entity level, unlike corporations which pay taxes on their earnings. For trusts, income is flowed to unit holders, unlike the shareholders of corporations who receive after-tax income net of corporate taxes. As such, many large public companies previously operating as corporations began to convert into income trusts in the late 1990s. The trend gained momentum after 2000 and the federal government became worried about the potential erosion of tax revenues. In order to address the tax revenue issues, the federal government introduced the Specified Investment Flow-Through (SIFT) rules.

The main purpose of the SIFT rules is to tax certain amounts earned by publicly-traded income trusts and limited partnerships. The SIFT rules addressed the tax issues that were prevalent for income trusts and limited partnerships prior to 2006. Income from a business, which previously escaped entity level tax prior to 2006, is now subject to tax. Tax-exempt investors, such as pension funds, receive distributions from income trusts after-tax similar to corporations, thus eliminating the previous tax advantages.

Funds 4

CONTENT AREAS

INTRODUCTION

In this lesson, you will learn about funds and how they are structured in the financial markets.

This lesson takes approximately 45 minutes to complete.

LEARNING OBJECTIVES

At the end of this lesson, you will be able to:

1 | Explain the different fund categories.

2 | Discuss the national instruments applicable to public investment funds.

3 | Explain mutual funds, non-redeemable investment funds, and commodity pools.

4 | Discuss the regulations applicable to non-public investment funds.

5 | Explain non-public mutual funds and non-public non-redeemable investment funds.

6 | Discuss non-investment funds.

7 | Discuss segregated funds.

A FUND IS NOT AN INVESTMENT STRUCTURE

A fund is not an investment structure in the sense that it is not a separate legal form. From the perspective of investment structure, a fund will be structured as a corporation, limited partnership, or trust.

WHAT IS A FUND?

There are many investments which fall under the category of funds in the financial markets including:

- mutual funds
- exchange traded funds
- closed-end funds
- hedge funds
- venture capital funds
- private equity funds
- segregated funds

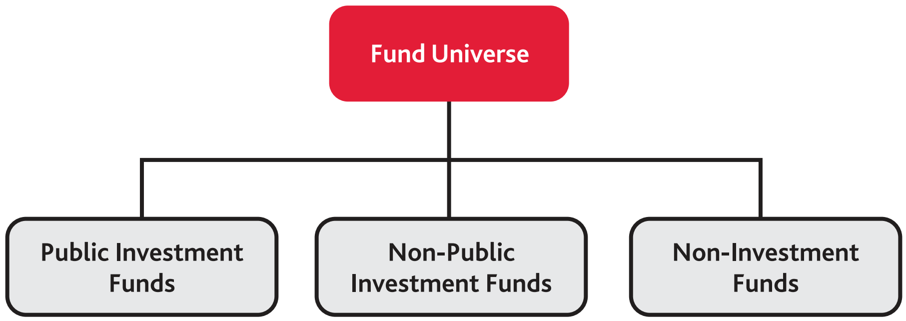
Generally, funds pool the money of many investors in order to invest in a portfolio of assets for the unit holders of the fund.

Funds are divided into 3 categories:

- **Public Investment Funds:** of reporting issuers, offered by prospectus
- **Non-Public Investment Funds:** offered under a prospectus exemption to certain qualified investors in the exempt market

- **Non-Investment Funds:** funds which:
  - exercise control over the investee
  - are actively engaged in the business of the investee
  - the funds' securities cannot be redeemed based on a proportionate amount of NAV

Figure 6.1



PUBLIC VERSUS NON-PUBLIC FUNDS

As with other securities distributed in the public and private (exempt) markets, there are unique features and requirements that apply to public funds and non-public funds as summarized in the table below.

Public Funds	Non-Public Funds
Public funds are issued by reporting issuers by prospectus in the public market	Non-public funds are issued under a prospectus exemption in the exempt market
The prospectus is filed and reviewed by the securities commissions/regulators	The offering documents are not filed or reviewed by the securities commissions/regulators
Investors: • No restrictions on who can invest (provided that they are of legal age, capacity)	Investors: • Offering is restricted to certain types of investors (e.g. accredited investors, eligible investors under the offering memorandum exemption, etc.)

PUBLIC INVESTMENT FUNDS

Public investment funds are the most highly regulated category of funds in Canada. Public investment funds are subject to the regulations established in the "81 Series" of national instruments enacted by the CSA, most notably:

- National Instrument 81-101 Mutual Fund Prospectus Disclosure (NI 81-101)
- National Instrument 81-102 Investment Funds (NI 81-102)
- National Instrument 81-105 Mutual Fund Sales Practices (NI 81-105)

Under the national instruments for public investment funds, provisions have been established governing:

- form of prospectus
- restrictions with respect to the portfolio including
  - concentration
  - control
  - types of investments
  - leverage
  - money market funds
- sales practices

Public investment funds are also subject to the continuous disclosure requirements established in National Instrument 81-106 Investment Fund Continuous Disclosure (NI 81-106) which include:

- financial statements
- financial disclosure
- management report of fund performance
- quarterly portfolio disclosure
- annual information form
- proxy voting and proxy solicitation disclosure
- material change reports
- calculation of net asset value
- calculation of management expense ratio

The issuers of public investment funds are reporting issuers and the securities are sold by prospectus. Therefore, public investment funds can be sold to investors without restriction and, unlike non-public investment funds, investors do not need to qualify for exemptions.

Public investment funds include:

- mutual funds
- non-redeemable investment funds
- commodity pools

MUTUAL FUNDS

Mutual funds are the most common type of public investment fund, attracting the highest assets world-wide in investment funds. The defining characteristics of mutual funds are summarized below.

- **Redeemable:** Mutual funds are redeemable, meaning that the unit holders are entitled to redeem units, on demand, and receive a proportionate amount for their units based on the current net asset value (NAV).
- **Net asset value (NAV):** Mutual funds follow a strict valuation regimen which allows them to determine the value for their net assets in the portfolio (in most cases on a daily basis) and then determine the NAV per unit. The NAV per unit is published in financial publications/media.
- **Open-ended:** Mutual funds are "open-ended" and they continuously issue and redeem units, so the number of units outstanding varies from day to day.

Mutual funds can be structured as corporations or trusts. The tax treatment of the mutual fund will depend on whether the mutual fund is structured as a corporation or a trust.

NON-REDEEMABLE INVESTMENT FUNDS

A non-redeemable investment fund is one that has a primary purpose to invest the pooled money from its investors into a diversified portfolio, but is not:

- a mutual fund;

and is not an issuer that:

- invests for the purpose of control over another issuer it invests in; or
- invests for the purpose of being actively involved in the management of the issuer it invests in.

A public non-redeemable investment fund is that of a reporting issuer which is offered by prospectus and is subject to NI 81-102 and NI 81-106.

Non-redeemable investment funds do not have the NAV and redemption features of a mutual fund. Absent the necessity to provide for liquidity in order to fund redemptions, non-redeemable investment funds have the flexibility to invest in assets with limited liquidity.

The securities of non-redeemable investment funds typically are traded on a stock exchange. Selling on the public market is the primary liquidity option for an investor in securities of a non-redeemable investment fund.

Non-redeemable investment funds include:

- closed-end funds
- exchange-traded funds
- flow-through limited partnerships

CLOSED-END FUNDS

Closed-end funds are diversified portfolios where a fixed number of shares of the portfolio are issued. Closed-end funds do not have a redemption feature and most commonly the shares of closed-end funds trade on a listed exchange in the same manner as listed common shares.

Closed-end funds generally trade at a discount to the NAV of its investment portfolio. The discount essentially reflects a market adjustment to reflect the costs of the fund including management fees. Unlike mutual funds, closed-end funds have no limits on short selling.

EXCHANGE-TRADED FUNDS

Exchange-traded funds (ETFs) are "open-ended" investment funds that trade on listed exchanges. As such, ETFs are generally highly liquid. ETFs invest in diversified portfolios, most commonly with the purpose of replicating a stock index or other financial benchmark or market sector.

The securities of ETFs are redeemable, but the redemption amount is not a proportionate share of NAV which makes them different and unique from mutual funds. The redemption price for an ETF is set relative to another benchmark (typically a fixed percentage discount of the closing price of the ETF's securities on the exchange). Accordingly, ETFs are not mutual funds and are considered non-redeemable for the purposes of securities legislation.

Unlike mutual funds, ETFs can use derivatives and alternative investment strategies to replicate the index that they follow. In the case of inverse, leveraged, and inverse leveraged ETFs, the fund seeks to generate returns opposite (inverse) of the index, returns which exceed the index by a multiple (e.g. 2X or 200%), or both. ETFs use derivatives, alternative investment strategies, and leverage in order to achieve the desired inverse/leveraged results.

FLOW-THROUGH LIMITED PARTNERSHIPS

Flow-through limited partnerships are diversified investment funds which invest in tax-advantaged investments and provide the investors of the fund with tax incentives from the flow-through of tax benefits through the limited partnership. One of the primary reasons investors purchase securities issued by flow-through limited partnerships is to receive the tax benefits.

The tax benefits from a flow-through limited partnership accrue to the original investor and are not continuous. As such, securities of flow-through limited partnerships do not generally trade on an exchange, although some do. The securities of the limited partnership are also not redeemable. After the tax benefits have been allocated to investors, the flow-through limited partnership units are most commonly converted to a conventional public mutual fund at which point there may be a liquidity facility for the investors.

COMMODITY POOLS

Commodity pools are a special sub-set of public investment funds which focus on investing in commodities in a way that is not permitted under the investment restrictions in NI 81-102. Rather, commodity pools are subject to the regulations in National Instrument 81-104 Commodity Pools (NI 81-104).

NON-PUBLIC INVESTMENT FUNDS

A non-public investment fund is a fund that is not a reporting issuer. Non-public investment funds distribute their securities under an exemption from prospectus requirements in the exempt market.

Non-public investment funds are not subject to the regulations established in NI 81-101 or NI 81-102, including the restrictions with respect to concentration, control, types of investments, and leverage. Absent these restrictions, non-public investment funds have less protection from the perspective of liquidity and asset mix and therefore could be subject to substantially higher risk than public funds.

The issuers of non-public investment funds are sold under an exemption from prospectus requirements. As such, non-public investment funds can only be bought by investors who meet the criteria of certain exemptions (e.g. accredited investor exemption, eligible investor under the offering memorandum exemption, etc.).

Non-public funds include:

- non-public mutual funds
- non-public non-redeemable investment funds (e.g. hedge funds)

NON-PUBLIC MUTUAL FUNDS

A non-public mutual fund is a mutual fund that is not a reporting issuer which distributes its securities under a prospectus exemption, but has the features of a mutual fund in that:

- the fund is redeemable – the unit holders are entitled to redeem units, on demand, and receive a proportionate amount for their units based on the current net asset value (NAV)
- the fund determines its net asset value (NAV) and NAV per unit

While non-public mutual funds are not subject to NI 81-101 or NI 81-102, the disclosure requirements established in National Instrument 81-106 Investment Fund Continuous Disclosure (NI 81-106) apply to both public and non-public mutual funds (except in Alberta, British Columbia, Manitoba, and Newfoundland and Labrador). Therefore, non-public mutual funds are required to issue certain disclosure including:

- financial statements
- financial disclosure
- calculation of management expense ratio

A non-public mutual fund is any mutual fund that is not a reporting issuer including:

- pooled funds
- private commodity pools

POOLED FUNDS

Pooled funds are a common type of non-public mutual fund whereby a registered portfolio manager establishes the fund with the purpose of pooling investments for its managed account clients. The pooled fund offers a convenient and efficient way to allocate client participation in securities transactions.

Commonly, exempt market dealers (EMDs) cannot participate in pooled funds since the securities of the pooled fund are not offered outside the portfolio manager's existing pool of clients. In some circumstances, a portfolio manager will open up their pooled fund to investors outside of their managed account clients and an EMD could participate in that distribution.

PRIVATE COMMODITY POOLS

A private commodity pool is a non-public fund that focuses on investing in commodities and is not a reporting issuer.

RISKS OF NON-PUBLIC MUTUAL FUNDS

There are certain risks you must be aware of with respect to non-public mutual funds. For example, the redemption rights associated with a private mutual fund may be drawn out over a longer period of time than is typical for a public mutual fund. Absent the protections provided under securities legislation for mutual funds offered by prospectus, there are risks associated with non-public mutual funds that you should make your clients aware of.

NON-PUBLIC NON-REDEEMABLE INVESTMENT FUNDS

Non-redeemable investment funds are typically issued by reporting issuers, such as closed-end funds and ETFs, and the securities are listed and traded on exchanges. This provides liquidity and compensates for the exclusion of a redemption feature.

In the case of a non-public non-redeemable investment fund, the investors must be prepared to endure an illiquid investment until a liquidity event is achieved (such as the wind-up of the fund at a set future time). The most common type of non-public non-redeemable investment funds are hedge funds which are structured as limited partnerships.

HEDGE FUNDS

Hedge funds are investment funds which invest in a portfolio of assets and units are issued to investors by way of offering memorandum. Unlike mutual funds, the objective of hedge funds is to achieve absolute returns under all market conditions, whether markets are up or down. Hedge funds are sometimes referred to as "market neutral" to describe this objective. In order to achieve absolute returns, hedge funds use derivatives and alternative investment strategies including short selling, leverage, concentrated positions, and arbitrage transactions.

NON-INVESTMENT FUNDS

A non-investment fund is a portfolio organized as a fund with the primary purpose to invest money provided by its security holders, but is not:

- a mutual fund
- a non-redeemable investment fund

Non-investment funds have the following unique characteristic:

- **active involvement:** post-investment, the managers of non-investment funds generally get involved in the investee in roles such as board seats and management positions and will often get involved in running and organizing the day-to-day business

Non-investment funds are not subject to the regulations established in NI 81-101, NI 81-102, or NI 81-106. Therefore, none of the safeguards with respect to disclosure, reporting, investing practices, and portfolio content are available to the investors of non-investment funds.

Common non-investment funds include:

- venture capital funds
- private equity funds
- private real estate funds

RISKS

Non-investment funds are inherently risky investments for reasons summarized in the table below.

Risks of Non-Investment Funds	
Risk	**Details**
Liquidity Restraints	• no redemption feature • no secondary market
Long Duration	• exit strategy involves development of the investee to the point where they can achieve a liquidity event (e.g. sale, IPO, refinancing) • investors have to wait (in some cases several years) until the liquidity event occurs
Risk of Business Failure	• risk of business failure by the investee is high • earliest stage investor (venture capital funds)

MANAGEMENT FEE

The role of the manager of a non-investment fund is quite different from the role of a portfolio manager of a public investment fund such as a mutual fund or an ETF. To a certain extent, the manager of the non-investment fund will be running one or more businesses and taking on the risk that deferred compensation may not be realized. In some cases, there is minimal cash to pay fees during the term of a typical investment. To compensate, a typical fee structure for a non-investment fund would be a regular management fee (typically paid monthly) and a deferred fee or carried interest representing a significant participation in a liquidity event for the fund's investment portfolio (e.g. sale of an investee). A typical fee would be a 2% per annum management fee plus a carried interest of 20%

(usually referred to as a "2 and 20" fee arrangement). The 20% is usually measured on the appreciation in value of the investment relative to the acquisition cost to the fund.

FUND EXPENSES

Unlike public investment funds such as mutual funds and ETFs, non-investment funds are not required to track and report on the management expense ratio (MER). MER is one measure of how efficiently a fund is operated. In the public domain, investment fund managers often absorb a portion of fund expenses to maintain a competitive MER. Since non-investment funds are not required to calculate and publish MER, there is not the same competitive element.

VENTURE CAPITAL FUNDS

Venture capital funds are funds with the primary purpose to invest money provided by its security holders in securities of start-up issuers or small to medium-size issuers. The securities acquired by venture capital funds are generally not those of publicly listed companies.

Venture capital funds have the following defining characteristics:

- **early-stage, high-risk:** venture capital funds tend to invest in high-risk, early-stage businesses where capital is difficult to raise from other sources
- **target private issuers:** the target issuers are often, though not exclusively, private issuers (i.e. not reporting issuers)

Venture capital funds are commonly actively involved in the investee issuers which is what differentiates the funds and defines them as non-investment funds.

PRIVATE EQUITY FUNDS

Private equity funds are funds with the primary purpose to invest money provided by its security holders in securities of private issuer(s) to expand or revitalize the business of the issuer(s). The securities acquired by private equity funds are those of private and public companies.

Private equity funds have the following defining characteristics:

- **established businesses:** established businesses (in comparison to the early-stage businesses of venture capital funds) , significant growth potential or performance below potential
- **target private or public issuers** — both private and public companies

Private equity funds are commonly actively involved in the investee issuers which is what differentiates the funds and defines them as non-investment funds, though generally to a lesser extent than the managers of a venture capital fund.

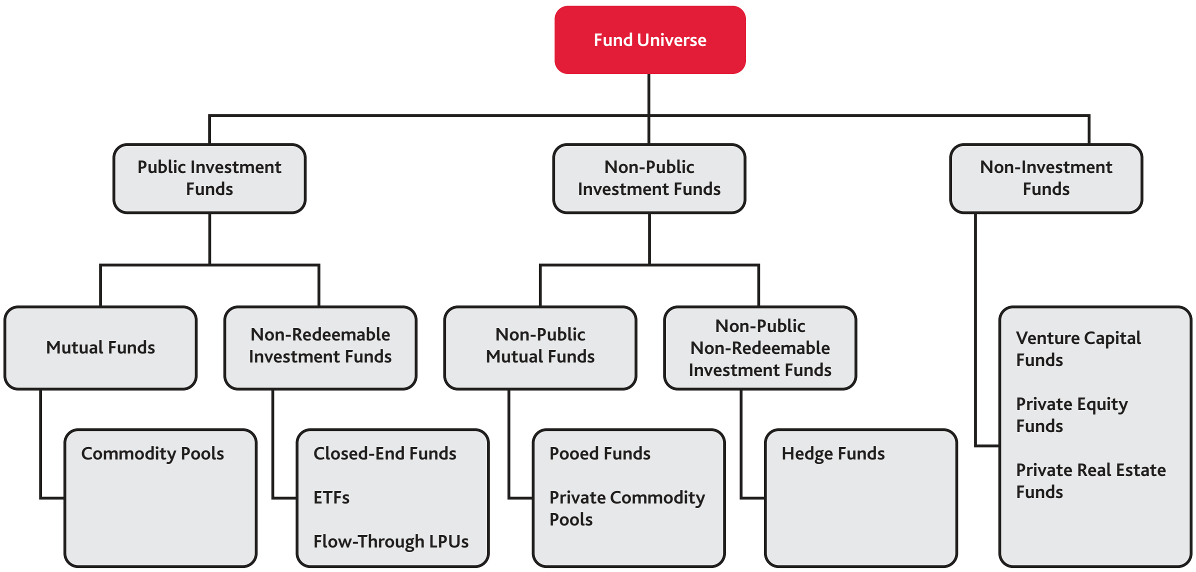
PRIVATE REAL ESTATE FUNDS

Private real estate funds are funds with the primary purpose to invest money provided by its security holders in real estate assets. Funds that own real estate clearly control the real estate and/or operate in the real estate business. Therefore, a real estate fund is neither a mutual fund nor a non-redeemable investment fund and, as such, it is a non-investment fund.

FUND UNIVERSE DIAGRAM

The diagram below illustrates the universe of funds sold under securities legislation.

Figure 6.2



SEGREGATED FUNDS

Segregated funds are funds that are issued by insurance companies and investors purchase them under an insurance contract. While segregated funds share many of the same characteristics as investment funds, segregated funds are not securities and are not subject to securities legislation.

Unlike investment funds, the portfolio of assets in a segregated fund belong to the insurance company, not the investors. The segregated fund units do not represent securities owned by the investors. Rather, the segregated fund units serve only to determine the value of benefits payable to the investors under the insurance contract.

Like investment funds, the potential return and risk attributes of a segregated fund are dependent on the underlying assets in the fund's portfolio, the investment manager's expertise, and market risks. In addition, segregated funds also provide a guarantee of 75% or more of the principal investment, some guarantee 100%, if held for 10 years. However, the guarantees in segregated funds come with fees and expenses that are higher than those of investment funds. EMDs and Dealing Representatives cannot sell segregated funds to investors. In order to offer segregated funds, you must be dually licensed as an insurance agent and this must be disclosed to your EMD as an outside business activity (OBA) before you can begin conducting insurance business.

Asset-Backed Securities 5

CONTENT AREAS

INTRODUCTION

In this lesson, you will learn about asset-backed securities and how they are structured in the financial markets.

This lesson takes approximately 10 minutes to complete.

LEARNING OBJECTIVES

At the end of this lesson, you will be able to:

1 | Explain what asset-backed securities are.

2 | Explain how assets are securitized.

3 | Discuss the purpose of securitization.

4 | Describe the roles in the securitization process.

5 | Describe the features of asset-backed securities.

WHAT ARE ASSET-BACKED SECURITIES?

Similar to investment funds, asset-backed securities are diverse portfolios of assets which are sold to investors as securities; each security represents a piece of the portfolio. Unlike investment funds, asset-backed securities invest in pools of assets which are receivables including:

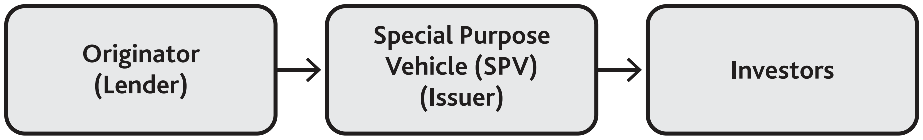
- mortgages
- car loan receivables
- credit card receivables
- consumer loans
- corporate/sovereign loans
- home equity loans
- lease/trade receivables

Similar to investments funds, an asset-backed security is not an investment structure in the sense that it is not a separate legal form. From the perspective of investment structure, an asset-backed security is structured as a trust.

HOW ASSETS ARE SECURITIZED?

1. The securitization of assets begins with the “originator”, the financial institution with the assets (for example mortgages). The originator creates the pool of assets and sells them to a “special purpose vehicle” (SPV), the entity (issuer) which is usually set up by the financial institution.
2. The SPV issuer finances the acquisition of the assets by raising the funds in the capital market by issuing securities.
3. Investors purchase the asset-backed securities.

Figure 6.3



PURPOSE OF SECURITIZATION

The objectives of securitization to the originator include:

- transferring the credit risk of the receivables to the investors
- an alternative way to raise capital, other than issuing bonds to borrow or issuing shares to raise shareholder capital
- a way to improve solvency, by moving the receivables off the balance sheet
- converting a non-tradable asset into a tradable security

EXAMPLE

CR Car Leasing Inc. needs to raise capital and does not want to borrow the funds since the company is already near limits with respect to its debt-to-equity. CR Car Leasing Inc. decides to sell some of its receivables in order to raise the capital. While there is no market for car leases, CR Car Leasing can pool the leases and sell the pool to an issuer. The issuer converts the pool of receivables leases into a tradable security and CR Car Leasing is able to raise the capital that it needs.

ROLES IN THE SECURITIZATION PROCESS

The participants in the securitization process are summarized in the table below.

Roles in the Securitization Process	
Borrower	• borrows from the financial institution (e.g. mortgage) • responsible for servicing principal and interest payments (e.g. mortgage payments)
Originator	• lender (financial institution, auto finance company, etc.) • lends money to the borrower • creates the pool of assets (mortgages, receivables, etc.) • sells the assets to the SPV issuer (commonly sets up the separate entity SPV as well)
Special Purpose Vehicle	• issuer of the securities • offers the securities for sale in the capital market
Trustee	• third party • administers the trust that holds the underlying pool of assets • disburses payments to investors

Roles in the Securitization Process	
Credit Enhancement	• improves the credit worthiness and includes: ◦ senior/subordinated structure (e.g. tranches) ◦ additional collateral ◦ increased cash reserves ◦ insurance
Investors	• investors buy the asset-backed securities: ◦ institutional investors ◦ retail investors

FEATURES OF ASSET-BACKED SECURITIES

The investors of asset-backed securities receive the principal and interest earned on the underlying assets in the portfolio. In essence, the debt payments that the borrowers make on their mortgages, loans, etc. are flowed through to the investors of the asset-backed securities. Mortgage-backed securities (MBS) are a common form of asset-backed security.

When assets are "securitized", they are converted from non-tradable assets into tradable securities. The securitization of the underlying assets enables the lending institutions who own the receivables to transfer some of the risks of ownership to the investors of the asset-backed securities.

The more common risks associated with asset-backed securities include:

- **Credit risk**: the risk of loss arising from defaults (failure to repay) within the pool of assets
- **Prepayment risk**: the risk of loss arising from pre-payments (before maturity) which result in lower interest payments to the trust

The assets in the underlying pool are held in trust as collateral for the asset-backed securities. Commonly, credit enhancement will be used in order to improve the credit worthiness of the asset-backed security by way of senior/subordinated structures (i.e. tranches), additional collateral, increased cash reserves, insurance, or other means.

Asset-backed securities are offered through both the public and private markets. Asset-backed securities that are distributed in the private market are offered under the short-term securitized product exemption and must satisfy the criteria below.

To be eligible for exemption, the asset-backed security must:

- have high credit ratings, as defined in National Instrument 45-106 (NI 45-106), assigned by at least 2 designated ratings organizations (DROs)
- not have any credit ratings below a certain level, as defined in NI 45-106, assigned by any DRO
- have principal and interest obligations guaranteed by an approved "liquidity provider"
- be offered under an *Information Memorandum* in the prescribed form (Form 45-106F7)
- provide *Monthly Disclosure Reports* in the prescribed form (Form 45-106F8)
- provide certain disclosure for material changes, changes in credit ratings, defaults, etc.

The minimum denomination for an investment in an asset-backed security is typically $1,000, although some classes have higher minimum denominations. While some asset-backed securities are available to retail investors, the main market for asset-backed securities is institutional investors. Typically, most institutions do not make investments in asset-backed securities of less than $1 million.

The price of an asset-backed security will depend on the interest rate and the yield to maturity at the time the asset-backed security is traded. How quickly and easily a given asset-backed security can be sold determines its marketability. In general, for an asset-backed security to enjoy high marketability, there must be a significant trading volume and a large number of dealers in the security.

UNIT SUMMARY

Congratulations, you have reached the end of Unit 6: The Structures of Issuers.

In this unit you covered:

- Lesson 1: Corporations
- Lesson 2: Limited Partnerships
- Lesson 3: Trusts
- Lesson 4: Funds
- Lesson 5: Asset-Backed Securities

Now that you have completed these lessons, you are ready to assess your knowledge with a 10-question quiz. To start the quiz, return to the IFSE Landing Page and click on the Unit 6 **Quiz** button.

UNIT 7

REAL ESTATE AND MORTGAGE INVESTMENTS

INTRODUCTION

In this unit you will learn about real estate and mortgage investments.

This unit takes approximately 1 hour and 50 minutes to complete.

Lessons in this unit:

1. Real Estate Investment Trusts
2. Mortgage Investment Corporations
3. Land Development Limited Partnerships

Real Estate Investment Trusts 1

CONTENT AREAS

INTRODUCTION

In this lesson, you will learn about real estate investment trusts.

This lesson takes approximately 1 hour and 10 minutes to complete.

LEARNING OBJECTIVES

At the end of this lesson, you will be able to:

1 | Define what a real estate investment trust is.

2 | Discuss the history of real estate investment trusts in Canada.

3 | Explain the structure of real estate investment trusts.

4 | Describe the characteristics of real estate investment trusts.

5 | Explain the tax considerations of real estate investment trusts.

6 | Discuss the benefits of real estate investment trusts.

7 | Discuss the fees and expenses of real estate investment trusts.

8 | Explain the risk factors of real estate investment trusts.

WHAT IS A REAL ESTATE INVESTMENT TRUST?

A real estate investment trust (REIT) is an investment vehicle that invests in income-producing commercial real estate properties like office buildings and shopping malls, or residential apartment buildings.

The managers of the REIT raise capital by issuing units in a trust. In return for their investment, unit holders receive regular monthly or quarterly cash distributions, with the potential for capital appreciation if the underlying properties increase in value. The income received by the REIT, which is then passed along to its investors, is primarily rental or leasing income from its tenants.

A REIT in the United States (U.S.) is a corporation or business trust that is permitted to flow its income through to its shareholders without any corporate income tax. To qualify as a REIT, a corporation or trust must pay out almost all of its taxable income to its shareholders. It must also meet conditions limiting the nature of its assets and business activities. If it does, the U.S. REIT does not pay federal taxes on its income, which avoids the double taxation of regular corporations.

THE HISTORY OF REAL ESTATE INVESTMENT TRUSTS IN CANADA

In the early 1990s, open-end mutual funds that invested specifically in real estate existed in Canada. The Tax Act (Canada) at that time did not permit real property as an eligible investment for a closed-end investment trust, so real estate investment funds were structured as open-end funds. However, real estate investments, being illiquid assets, proved to be inappropriate investments for open-end mutual funds requiring liquidity for redemptions.

In the late 1980s and early 1990s, the collapse in the real estate market resulted in a surge of redemptions from real estate mutual funds and the funds struggled to meet redemptions. The mutual funds also experienced valuation issues because the underlying properties in the funds were based on out-of-date appraisal values. As a result, the mutual funds paid out more on their redemptions than the NAV of the funds. The mutual funds turned to the securities commissions for approval to suspend payments and restructure the funds.

Changes to the Tax Act in 1994 made it possible for real property to be the capital property of a trust, paving the way for the establishment of REITs as closed-end trusts. Unlike open-end funds, closed-end funds issue a set number of shares which are traded on a listed exchange, thus relieving the issuer from redemption obligations and liquidity constraints. In the 2000s, open-end REITs re-emerged with modified redemption features. The new generation of REITs offer modified redemptions that satisfy the requirements of an open-end trust as defined under the Tax Act. The REITs may still be traded on a stock exchange, but the unit holders also have the right to redeem their units through the trust itself, subject to restrictions:

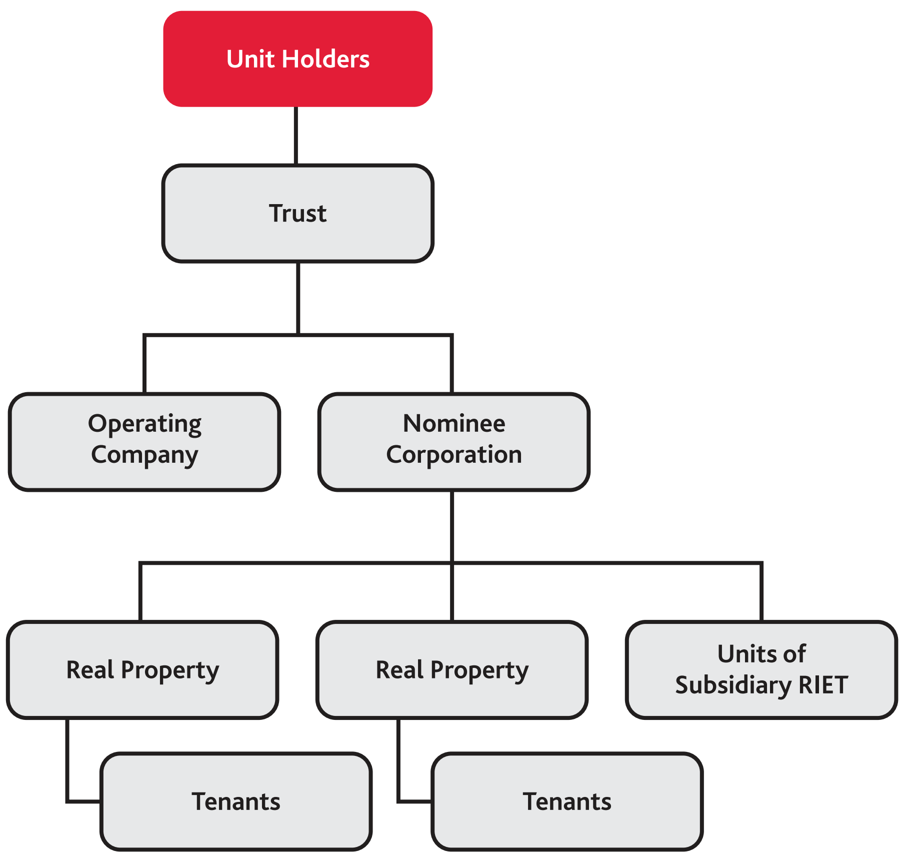
- The redemption price may be less than the current market price
- It may not be payable immediately in cash
- There may be a limit on how much the fund will pay to unit holders at a given time
- In certain circumstances, the right of redemption may be suspended

THE STRUCTURE OF REITs

REITs are diversified portfolios which are structured as trusts. The money pooled from the unit holders is used to purchase real property through a nominee corporation. Rental income is paid by the tenants of the real property and is flowed through to the unit holders. The nominee corporation is used to facilitate the process from both an administrative and taxation point of view.

The diagram below illustrates the structure of a REIT.

Figure 7.1



NOMINEE CORPORATION

The nominee corporation between the trustees and the property owned by the REIT is a common arrangement. The nominee corporation owns legal title to the real property. The REIT's trustees are beneficiaries of the property held by the nominee corporation. The use of a nominee corporation means the trustees do not have to sign any contracts themselves. If they did, it might put them in a position to be personally liable for any obligations of the REIT.

OPERATING COMPANY

Under the Tax Act, a REIT may not carry on as a business or it will lose its favorable tax status as a mutual fund trust. However, a REIT may have a subsidiary company, such as a property management company, to carry out the business activities of the properties including rent collection, maintenance, etc.

PROPERTY MANAGER

The property manager may be external or internal to the REIT. The importance of the property manager should not be underestimated. The property manager needs to make sure that properties have sufficient occupancy to maintain rental/lease payments to the REIT and that rental payments are collected properly. If the property manager cannot transfer enough rental income to the REIT, distributions to unit holders may be either suspended or reduced.

SUBSIDIARY REITs

Some REITs will hold units of another REIT or a diversified portfolio of REITs that it can adjust as market conditions change.

PORTFOLIO MANAGER

Normally, the trustees of a REIT delegate the portfolio management function to a manager. The manager provides the following services:

- management of the REIT's property portfolio
- strategic advice on property investments, financing, and operating policies
- administrative functions
- dealings with financial institutions
- accounting functions
- investor relations

REITs may engage an external third-party manager under an external management arrangement. However, external management fees can be prohibitive and may include management fees, fees for acquisitions, a percentage of gains on dispositions, fees for development and financing, and incentive fees for achieving certain thresholds.

The trend has been to use internal managers rather than external managers and most established Canadian REITs now have the ability to run their own management team in-house. The management team is employed by the REIT or one of its operating entities.

Internal managers are usually paid with a combination of salary, bonus, and other incentive plans including unit option plans.

CHARACTERISTICS OF REAL ESTATE INVESTMENT TRUSTS

INVESTMENTS

REITs are designed to provide a regular stream of distributions to its unit holders. To maintain these payments, REITs invest primarily in a diversified portfolio of income producing properties.

Commonly, the *Declaration of Trust* for most REITs establishes certain restrictions including:

- **concentration limits:** which prevent the REIT from investing a certain percentage of the portfolio in any one property
- **limits on undeveloped land:** usually limited to a small percentage, subject to conditions requiring that the investment is related to renovation, expansion, or development of an income producing property
- **mortgage limits:** usually limited to a small percentage (e.g. 20% of unit holder equity or 15% of book value), subject to conditions including:
    - the requirement that the underlying property is income producing
    - the maximum loan-to-value ratio (e.g. 75%)
    - the debt service coverage ratio (e.g. 1.2 times, or 20% more than mortgage interest)

Other matters specific to REITs covered in the *Declaration of Trust* include:

- **lease/sublease restrictions:** restricting the lease or sublease of property to any person where that property's fair market value is greater than a certain percentage of the REIT's unitholders' equity or book value
- **indebtedness:** commonly prohibited from incurring debt totaling more than a certain percentage of the gross book value of the REIT's assets (e.g. 40% - 70%) and limits on debt incurred at floating rates, short-term debt, or the REITs ability to guarantee loans, etc.
- **property insurance coverage:** the parameters related to adequate property insurance coverage
- **independent appraisals:** the requirement to obtain independent property appraisals
- **environmental audit:** the requirement to obtain independent environmental audits

It is important to note that these investment restrictions and other limits are not mandated by securities or tax legislation. You must examine the REITs *Declaration of Trust* thoroughly as a matter of your due diligence obligations.

TYPES OF REITs

REITs in Canada generally invest in the following types of real estate:

- nursing homes
- hotel properties
- shopping malls
- self-storage facilities
- industrial facilities
- apartments
- industrial and office buildings

Some REITs will hold different types of real estate investments in an effort to diversify across real estate type. Others will be more narrowly focused on one or two areas but diversify geographically by investing in different real estate markets. Others again will be even more narrowly diversified in one sector in one region.

EXAMPLE

Boardwalk REIT owns and operates residential multi-family revenue producing properties. Its portfolio is concentrated mainly in Alberta, British Columbia, Saskatchewan, Ontario, and Québec.

EXAMPLE

Chartwell Retirement Residences REIT is focused exclusively on owning and managing a variety of seniors housing communities in Canada and the U.S.

EXAMPLE

Calloway Investment Trust REIT concentrates almost exclusively on shopping centers across Canada.

TRADING PUBLIC REITs

Publicly traded REITs are bought and sold on stock exchanges in a similar fashion as shares of public corporations. Unit holders of REITs of a publicly traded open-end trust may also redeem their units with the REIT itself, subject to restrictions.

REDEMPTIONS

While REITs structured as open-end trusts must provide a redemption feature in order to qualify under the Tax Act, the redemption of REIT units may be subject to certain conditions. Some of the common redemption restrictions are summarized in the table below.

Redemption Restrictions	
Discounted Redemption Price	• the redemption price offered by the REIT is less than the current market price (e.g. 90% of the current market price) • used to incent unit holders of public REITs to sell their units in the market first
Maximum Redemption Price	• a limit on how much the REIT will pay a unit holder in a given period of time • a dollar limit the REIT will redeem in a month to all unit holders attempting to redeem
***In Specie* Redemption**	• the redemption may not be payable immediately in cash • the REIT may satisfy a redemption by issuing a portion of its property or illiquid assets in excess of a maximum redemption price
Suspension of Redemption	• in certain circumstances, rare cases • the right to redeem units may be suspended • would involve a cease trade order under securities law or suspension of normal trading on a stock exchange

LIQUIDITY AND PRIVATE REITs

Private REITs are not as liquid as public REITs. As with all other exempt securities, there is no secondary market for private REITs and there are usually resale restrictions. Therefore, the only option available to unit holders would be to redeem the units through the issuer, subject to the REIT's redemption restrictions. The redemption price for units of private REITs is largely based on the value of the underlying properties, which is determined by an independent appraisal.

YIELD

Units of a REIT trade primarily on the basis of their yield. The most common performance measurement for REITs that investors look at is yield. The yield is calculated by dividing the annual cash distributions by the current market price and is expressed as a percentage.

$$\text{yield} = \frac{\text{Annual distribution (\$)}}{\text{Market price (\$)}}$$

Investors compare REIT yields to those of other investments like fixed income products and equities. Yields are a rough guide to the quality of a REIT and should not be looked at in isolation. High annual distributions may not be sustainable over many periods, depending on other factors such as:

- quality of tenant
- leverage
- whether new properties are purchased and existing ones maintained
- general real estate market conditions
- quality of REIT management

Investors should also look at total return.

TOTAL RETURN

Total return is the change in value of the REIT over a given period, assuming reinvestment of distributions, expressed as a percentage of the initial investment. It accounts not only for distributions but also for the changing market price of the units.

$$\text{Total return} = \frac{\text{dividends} + (\text{sale proceeds} - \text{ACB})}{\text{purchase price of the units}}$$

EXAMPLE

Marta bought 100 units of SOS.UN REIT at \$20 per unit. Over the next two years, she received \$2 per unit in distributions. At the end of the two years, Marta sold these units for \$26 each. Her total return was 40%, calculated as ((dividends + (sale proceeds – ACB)) ÷ purchase price).

$$\text{Total Return} = \frac{\$2 + (\$26 - \$20)}{\$20}$$

$$\text{Total Return} = \frac{\$8}{\$20}$$

$$\text{Total Return} = 40\%$$

The total return is convenient because it is easily calculated with basic arithmetic. However, it is still only an approximation of returns because it does not take into account when the distributions are paid during the year.

Total return assumes the distributions received during the period in question were received at the end of that period. It may be useful over a one- or two-year period, but the longer the period in question, the more inaccurate total return calculations become. More accurate measurements incorporate the time value of money.

DISTRIBUTION OF REAL ESTATE INVESTMENT TRUSTS

PUBLICLY TRADED REITs

When a REIT is a reporting issuer, like other publicly traded securities, the REIT is brought to market by means of an initial public offering (IPO) under a prospectus.

National Policy 41-201 Income Trusts and Other Indirect Offerings (NP 41-201) establishes certain requirements specific to REITs including the following:

- prospectus disclosure including:
  - executive compensation
  - distributable income (DI)
  - financial information
  - material debt
- description of the REIT and its business properties
- financial statements and discussion of operating results
- the form of any forecasts made
- the consolidated debt and equity capital structure
- governance and compensation structures
- risk factors

Publicly traded REITs trade on the stock exchanges and are listed with the suffix ".UN" (e.g. RioCan Real Estate Investment Trust: REI.UN).

PRIVATE REITs

Private REITs are offered in the exempt market. The structure of a private REIT is very similar to a public REIT, the main difference being that they do not trade on a stock exchange and they must be structured as an open-end unit trust. The units of a private REIT must be bought and redeemed directly from the REIT issuer, there is no secondary market.

As with all securities offered in the exempt market, private REITs are distributed primarily by way of an offering memorandum (OM) and may only be purchased by certain investors who qualify for exemption (e.g. accredited investor exemption, eligible investor under the offering memorandum exemption, etc.).

You should thoroughly review the offering documents (offering memorandum) as a matter of your due diligence obligations.

TAX CONSIDERATIONS

The tax considerations of any investment should be determined in consultation with a professional tax adviser. For information purposes, the general tax considerations in relation to REITs are outlined below.

REITs AS DEFINED UNDER THE TAX ACT (CANADA)

REITs are flow-through investments, meaning that tax is not paid by the corporation. Rather, income is flowed through to the investors. The criteria for eligibility, under the Tax Act (Canada) are summarized in the table below.

Real Estate Investment Trusts (REITs)
A real estate investment trust (REIT), as defined under the Tax Act (Canada), is a Canadian trust which: • does not hold any property other than Qualified REIT Properties* • 95% of the trust's revenues come from rent from real or immovable properties, interest, dividends, royalties, or capital gains from the sale of real property (i.e. the "95% passive revenue test") • at least 75% of the trust's revenues come from rent, mortgage interest, or capital gains from real or immovable properties (i.e. the 75% revenue test) • the total fair market value of all real or immovable properties, plus cash, certain debt securities, and other highly liquid short-term investments, must be at least 75% of the trust's equity value (i.e. the 75% value test)

* Qualified REIT Property, as defined under the Tax Act (Canada), is summarized in the table below.

Qualified REIT Property	
Real or immovable property	• the purchase or lease of property such as land or buildings • investment in the securities of another entity that qualifies as a REIT • certain kinds of depreciable capital property
Securities of an operating subsidiary	• securities of a trust or corporation that derives all, or almost all, of its revenues directly from maintaining, improving, leasing, and/or managing property owned by the REIT (alone or in partnership with others) • allows the trustees of the REIT to invest in subsidiaries that manage their properties for them instead of doing it directly
Securities of a nominee corporation	• the REIT invests in the nominee corporation • the nominee corporation only holds legal title to the property of the REIT, or legal title to property held by another subsidiary of the REIT
Ancillary property	• ancillary property held by the REIT that is related to the activities of the trust but not essential to those activities (e.g. computers, photocopiers, office furniture, etc.)

TYPES OF INCOME

The income earned by a REIT and subsequently passed along to investors generally consists of one or more of the following:

- rental income
- dividend income
- capital gains
- return of capital

From a tax perspective, unit holders must report income from the REIT, whether it was paid to the unit holder in cash or not (e.g. reinvested distributions).

TAXATION OF UNIT HOLDERS

The income received by the unit holders of a REIT is received in its original form. For example, capital gains earned by the REIT are flowed through to the unit holders as capital gains. The unit holder will receive form T3 (Statement of Trust Allocations and Designations) and form T5 from the REIT which will report the capital gains, dividends, income, and taxable amounts to the unit holder.

The unit holders must report the income received by the REIT and reported on the T3 and T5 forms in their tax filings for that year. The tax treatment of unit holders' REIT income is summarized in the table below.

Taxation of Unit Holders	
Rental Income	• 100% of the unit holders marginal tax rate • no favorable treatment • income is from a property and cannot be used to calculate RRSP contribution room
Dividends	• dividends are grossed-up and reported as taxable income • dividend tax credit is deducted from tax payable
Capital Gains from Distributions	• the unit holder's taxable capital gain must be calculated (i.e. capital gain X 50%) • the unit holder pays tax on the taxable capital gain
Capital Gains on Disposition (Redemption)	• the profit from the redemption of REIT units (sale proceeds - adjusted cost base) • must consider distributions which were paid as a return of capital in the adjusted cost base
Return of Capital	• no tax in the year the distribution is paid • tax deferred • taxed when the units are redeemed

RETURN OF CAPITAL

Under the Tax Act, a REIT is entitled to deduct capital cost allowance (CCA) from income with respect to its depreciable capital property. Normally, a REIT's declaration of trust will stipulate that the maximum CCA be deducted in a year to reduce or eliminate its taxable income.

However, CCA is not deducted when computing a REIT's distributable income (DI). The result is that usually, a REIT's DI will be larger than its taxable income, meaning a portion of a distribution made to a unit holder will consist of income that was not taxable to the REIT. Part of the unit holder's distribution is thus tax-sheltered by CCA in the year it is received. This part of a unit holder's distribution is treated as a return of capital. The portion of a distribution allocated to return of capital is usually about 75% - 85%.

TAX TREATMENT OF A RETURN OF CAPITAL

A return of capital is not taxable to the unit holder in the year it is received. Instead, his or her adjusted cost base (ACB) is reduced by the amount of the return of capital.

EXAMPLE

Grace owns 100 units of HiRize REIT for which she paid $15 per unit at the beginning of this year. She receives a distribution of $1 per unit, 20% is income from property and 80% is a return of capital. From the distribution, she must include $20 in her taxable income, or ($0.20 × 100). She will not pay tax this year on the $0.80 per unit allocated to return of capital. Instead, she will reduce her ACB per unit by $0.80 per unit to $14.20.

Income is taxed in full in the year it is received, whereas tax on a return of capital is deferred until the year the units are sold and is taxed at the lower capital gains tax rate. By postponing the payment of tax on the return of capital, the REIT provides some tax deferral and as a capital gain, it is only taxed at 50% of the gain.

ADJUSTED COST BASE

A unit holder's adjusted cost base (ACB) at the time of disposition must capture the return of capital distributions paid to the unit holder. A return of capital distribution is not taxable when it is paid to the investor. However, a capital gain (or loss) will be realized when the investor eventually redeems the units. The capital gain will be greater (or the capital loss smaller) when a return of capital has been paid because the adjusted cost base was reduced.

EXAMPLE: RETURN OF CAPITAL (CASH DISTRIBUTION)

Sammah purchased units of CanMall REIT at two intervals last year: 1,000 units for $12/unit in January and 500 units for $12.50/unit in March. At the end of the year, the REIT made a distribution of $1.00 and $.60 per unit was a return of capital. Sammah took the distribution as cash. On June 30 of this year, she sold 500 units of her REIT. Summarized below is Sammah's adjusted cost base (ACB).

Transaction	Units	Purchase/ Sale Price	Transaction Value	ACB of Holdings	ACB/Unit
Year 1, Jan 1 purchase	1,000	$12.00	$12,000	$12,000	$12.00
Year 1, Mar 1 purchase	500	$12.50	$6,250	$18,250	$12.17
Year 1, Dec 31 return of capital portion of the distribution taken in cash	-	-	–$900[1]	$17,350	$11.57[2]
Year 2, June 30 redemption	–500	$12.75	$6,375	$11,565[3]	$11.57

1 The reduction in the ACB as a result of the December 31 distribution was determined as: $0.60 per unit × 1,500 units = $900.
2 (total ACB ÷ total units) or ($17,350 ÷ 1,500 = $11.57.)
3 The ACB of the units sold was $5,785, calculated as (500 × $11.57). The ACB of the remaining holdings is the difference between the ACB of 1,500 units less the ACB of the units sold or ($17,350 – $5,785) = $11,565.

Assuming that the 500 units were redeemed at a value of $12.75, Sammah realized a capital gain of $590, calculated as [(500 units × $12.75) – $5,785]. 50% of this gain, or $295 would be subject to tax.

EFFECT OF A DIVIDEND REINVESTMENT PLAN (DRIP)

If the unit holder is a member of a dividend reinvestment plan (DRIP), the full amount of the distribution is used to purchase more units of the REIT. A purchase of more units will also change the ACB of the investment.

EXAMPLE: RETURN OF CAPITAL (REINVESTED DISTRIBUTION)

Sammah purchased units of CanMall REIT at two intervals last year: 1000 units for $12/unit in January and 500 units for $12.50/unit in March. At the end of the year, the REIT made a distribution of $1.00 and $.60 per unit was a return of capital. Sammah reinvested the distribution through her DRIP plan. On June 30 of this year, she sold 500 units of her REIT.

Transaction	Units	Purchase/ Sale Price	Transaction Value	ACB of Holdings	ACB/Unit
Year 1, Jan 1 purchase	1,000	$12.00	$12,000	$12,000	$12.00
Year 1, Mar 1 purchase	500	$12.50	$6,250	$18,250	$12.17
Year 1, Dec 31 return of capital portion of the distribution	-	-	–$900[1]	$17,350	$11.57
Year 1, reinvested distribution	120	$12.50	$1,500	$18,850	$11.64[2]
Year 2, June 30 redemption	–500	$12.75	$6,375	$13,030[3]	$11.64

1 The reduction in the ACB as a result of the December 31 distribution was determined as: $0.60 per unit × 1,500 units = $900.
2 (total ACB ÷ total units) or ($18,850 ÷ 1,620 = $11.64.)
3 The ACB of the units sold was $5,820, calculated as (500 × $11.64). The ACB of the remaining holdings is the difference between the ACB of 1,620 units less the ACB of the units sold or ($18,850 – $5,820) = $13,030.

Sammah would have received $1,500 as a distribution, or ($1.00 × 1,500 units). A DRIP would have purchased additional units of the REIT. Assume the unit price was still $12.50. This would have purchased 120 units. The new ACB would be $18,850 or ($17,350 + $1,500). This would make a new ACB/unit of $11.64 or ($18,850 ÷ (1,500 + 120)).

Assuming that the 500 units were redeemed at a value of $12.75, Sammah realized a capital gain of $555, calculated as [(500 units × $12.75) – $5,820]. 50% of this gain, or $277.50 would be subject to tax.

SIFT RULES

In October, 2006, the federal government introduced the Specified Investment Flow-Through (SIFT) rules which established significant changes to the tax treatment of income trusts. The SIFT rules eliminated the tax advantages of income trusts and imposed new taxes on income trusts at corporate tax rates.

REITs are exempt from the SIFT rules but must meet certain conditions. One of the most important conditions is that rent received by the REIT must come from real or immovable properties.

The legislation specifically states that income will not be considered rental income from the following:

- income from any form of nursing or health care facilities
- payment for occupation of a room in a hotel or other similar lodging facility
- rent based on profits
- fees for managing or operating properties

REGISTERED PLAN ELIGIBILITY AND TFSAs

REITs are eligible for registered plans such as RRSPs, RRIFs, TFSAs, RESPs, and RDSPs.

BENEFITS OF REAL ESTATE INVESTMENT TRUSTS

REITs can provide the following benefits:

- **yield:** the potential for yields that are more attractive than other income generating securities during certain periods (e.g. when interest rates are low or where real estate markets are performing particularly well)
- **regular stream of income:** commonly generate monthly or quarterly distributions, typically predictable
- **potential long-term capital appreciation:** the potential for the underlying real property owned by the REIT to appreciate in value
- **low correlation relative to traditional equity or fixed income products:** the factors which impact the movement of equities and fixed income securities in the markets are generally not closely related to the factors that impact the movement of REITs
- **tax treatment:** the income earned by REITs is flowed through to the unit holders and is taxed at one level only (i.e. double tax is avoided), the unit holders receive the income generated by the trust in its original form (e.g. capital gains, 50% taxable), and distributions paid as a return of capital defers taxes payable
- **professional property management:** the professional skills provided by the REIT's trustees or its subsidiary property management company
- **liquidity:** REITs provide greater liquidity than holding real estate directly, public REITs are traded on stock exchanges and open-end REITs have some form of redemption feature
- **registered plans:** REITs are eligible for registered plans such as RRSPs, RRIFs, TFSAs, RESPs, and RDSPs

FEES AND EXPENSES

For REITs that have external management arrangements, the fees and expenses include the following:

- **Management fee:** based on a percentage of assets, often 0.25% (sometimes the manager is required to take a minimum amount of its base fee as units in the REIT)
- **Property management fee:** a percentage of gross revenues, usually between 2.5% - 3.5%, charged to the operation of the assets
- **Acquisition fee:** a percentage of the property's purchase price, often ranging from 0% -1.0%
- **Disposition fee:** a percentage of the property's selling price, often 0.5%, or a percentage of the gain (in some contracts, there is a minimum dollar value of dispositions that can be made by the REIT before the disposition fee is levied)
- **Incentive fee:** if a certain threshold of distributable income (DI) or funds from operation (FFO) per unit is reached

For REITs that have internal managers, the compensation paid by the REIT includes the following:

- Salary
- Bonus
- Incentive plan which may include:
  - *Unit option plan*: Similar to stock option plans in corporations, the REIT grants the employee the option to buy units in the REIT at a specified (strike) price. If the unit price of the REIT rises above the option's strike price, the option holder can buy the REIT at the strike price and profit from the REIT's higher market price. Since managers' future profits are linked directly to the unit price of the REIT, many believe unit options are an effective way to align the interests of managers with the fortunes of the REIT. Unit option plans must follow the rules of the stock exchanges (e.g. cannot reserve/issue more than 10%)

- *Employee unit purchase plan*: Similar to employee share purchase plans in corporations, the REIT grants the employee the right to purchase units of the REIT with a percentage of their base salary and the REIT contributes to the employees unit purchase plan alongside the employee (e.g. matches the employee: buys 1 unit for every unit bought by the employee, or buys a percentage: buys (50%) 1 unit for every 2 units bought by the employee, etc.).
- *Long-term incentive plan*: Gives the participant the option to receive their annual bonus in the form of units of the trust, with the REIT matching the number of units received. Alternatively, a pool of funds may be set aside based on a percentage of a REIT's financial performance. These funds are then used to purchase units in the market on behalf of the participants.

RISK FACTORS

There are certain risks associated with REITs. The most apparent risks commonly associated with REITs are summarized below.

- **Vacancy:** One of the biggest risks that a REIT faces is vacancy of its properties. If the number of tenants drops by too much, the REIT will not receive sufficient rental or lease payments to pass along to unit holders as distributions.
- **Liquidity:** Real estate is not a liquid asset and large commercial or residential properties are even less liquid. For private REITs, there is no secondary market and securities regulations restrict the resale of the securities.
- **Rental Income:** If tenants are unable to pay their rent, the REIT's revenue will fall and distributions to the unit holders will be at risk. With commercial and retail REITs, in addition to minimum rent, the tenant pays a "percentage rent" which is a percentage of the tenant's revenues. This income would be at risk where the commercial/retail tenant is struggling or retail markets are in a downturn. Rent control legislation also limits how often rents can be raised and by how much.
- **Leverage:** A significant portion of a REIT's activities is financed using mortgages and lines of credit. This means it must have sufficient cash flow to meet interest and principal payments and still pay distributions to unit holders. In some cases, REITs leverage properties against the acquisition of other properties. This model increases the risk to investors where there is a default on one property secured against another property. REITs that are highly leveraged will have increased risk associated with the investment. It is important to examine how much debt a REIT is carrying relative to its book value.
- **Excess Distributions:** When a REIT's distribution exceeds its cash flow from operations, it is considered an excess distribution. Typically, excess distributions are funded by taking on debt. Borrowing to finance distributions incurs additional interest expense which further reduces the REIT's ability to pay future distributions. REITs that consistently obtain cash flows from financing sources other than from operations have a higher risk profile. Excess distributions that are financed by debt may indicate that the distributions are not sustainable and future distributions could be suspended. While National Policy 41-201 (NP 41-201), item 6.5.2 and OSC Staff Notice 51-724 (OSCSN 51-724) establish clear disclosure requirements pertaining to excess distributions for reporting issuers, REITs distributed in the exempt market are not obligated to provide these disclosures. It is therefore critical to examine these REITs to determine the amount of the distributions derived from cash flow from operations and any excess distributions funded by borrowed financing. Those REITs that consistently fund excess distributions via debt financing pose the risks of unsustainable distributions and the possibility that distributions could be suspended.
- **Market Conditions:** Unfavorable real estate market conditions can have a negative impact on a REIT. The strength of the real estate market will directly affect vacancy rates, rent payments, and the liquidity of the investments within the REIT.

- **Interest Rate Risk:** A change in interest rates will have various effects on the unit price of a REIT. In periods of low interest rates, many investors turn to REITs because their yield may be higher than on traditional fixed income products. If interest rates rise, new fixed income issues will reflect that increase and REITs may become less attractive. Where the REIT is leveraged, increased interest rates will translate into an increased interest expense which could put distributions at risk.
- **Property Management:** If the property manager does not keep the properties in good repair, their value will fall.
- **Development Risk:** For properties under development and/or renovation, development risks related to the project(s) would be applicable.
- **Environmental Risk:** Federal and provincial laws could hold the REIT, as an owner of property, liable for environmental issues.

Mortgage Investment Corporations

2

CONTENT AREAS

- What is a Mortgage Investment Corporation?
- Tax Considerations
- Benefits of Mortgage Investment Corporations
- Fees and expenses
- Risk Factors

INTRODUCTION

In this lesson, you will learn about mortgage investment corporations.

This lesson takes approximately 20 minutes to complete.

LEARNING OBJECTIVES

At the end of this lesson, you will be able to:

1 | Define what a mortgage investment corporation is.

2 | Describe the characteristics of mortgage investment corporations.

3 | Explain the tax considerations of mortgage investment corporations.

4 | Discuss the benefits of mortgage investment corporations.

5 | Discuss the fees and expenses of mortgage investment corporations.

6 | Explain the risk factors of mortgage investment corporations.

WHAT IS A MORTGAGE INVESTMENT CORPORATION?

A mortgage investment corporation (MIC) is an issuer and lending institution which:

- offers shares of the corporation to investors
- invests the proceeds from the offering into mortgages secured by real property by lending to mortgage borrowers

Figure 7.2

The MIC's shareholders receive income from the MIC mortgage pool. Similar to investors of mortgage-backed securities, the shareholders of MICs receive principal and interest earned on the underlying assets in the portfolio. In essence, the debt payments that the borrowers make on their mortgages are flowed through to the shareholders of the MIC. Additional revenue may be generated from various fees paid by the borrower, usually at the time the mortgage is funded.

THE CHARACTERISTICS OF MORTGAGE INVESTMENT CORPORATIONS

A mortgage investment corporation (MIC) is a pool of mortgages offered to investors as a security. The security is backed by mortgages which are secured against the real property mortgaged and it provides investors with an income stream by way of dividends.

LOAN-TO-VALUE RATIOS

Mortgages, by definition, are secured by real property. MICs will generally have investment guidelines which will establish limits for the loan-to-value ratio (e.g. 75% of the value of the property).

EXAMPLE

Ivan needs to obtain a mortgage for a property valued at $100,000. The MIC's loan-to-value ratio (LTV) is established at 75%. Therefore, the maximum amount that Ivan can borrow is $75,000.00.

FLOW-THROUGH INVESTMENTS

MICs are flow-through investments, meaning that tax is not paid by the corporation. Rather, income is flowed through to the investors. The criteria for eligibility for MICs, under the Tax Act (Canada), are summarized in the table below.

Mortgage Investment Corporations (MICs)
A mortgage investment corporation (MIC), as defined under the Tax Act (Canada), is a Canadian corporation which: • must have at least 20 shareholders • no shareholder may hold more than 25% of the MIC's total capital • at least 50% of a MIC's assets must be residential mortgages and/or cash and deposits insured by the Canada Deposit Insurance Corporation (CDIC) • may invest up to 25% of its assets directly in real estate • must not develop land or engage in construction • must not invest in assets or debts (mortgages) related to property outside of Canada • must distribute 100% of its net income to its shareholders • distributions paid from a MIC to its shareholders are considered income for tax purposes • annual financial statements must be audited by an independent accounting firm • may employ financial leverage by using debt to partially fund assets

INVESTMENTS

MICs can invest directly or indirectly in mortgages granted as security for loans to developers and owners of various types of real estate including commercial, industrial, and residential real estate, subject to limits defined under the Tax Act (i.e. 50% minimum must be invested in residential mortgages and/or CDIC insured deposits). MICs can also participate in syndicated mortgages with multiple lenders, subject to minimums.

ADMINISTRATIVE DUTIES

MICs can appoint administrators to provide services for the administrative, management, operational, and registration aspects of the MIC.

Administrative duties related to the MIC include:

- receipt and posting of mortgage payments
- funding new mortgages

- renewal of existing mortgages
- property insurance and tax follow up
- maintaining amortization schedules and bank records for the portfolio

AUDITED FINANCIAL STATEMENTS

MICs must be audited annually, at the fiscal year end, by an independent accounting firm and the audited financial statements must be made available to the shareholders of the MIC.

REDEMPTION

Most MICs issue common or preferred shares which can be surrendered for redemption under certain circumstances, subject to established time periods. For example, some MICs allow investors to redeem shares, on a periodic basis, for up to 95% of the trading price. Commonly, monthly redemption payment dates are established in the offering documents (offering memorandum) for the MIC.

DISTRIBUTION OF MORTGAGE INVESTMENT CORPORATIONS

Most commonly, MICs are offered to investors under exemptions from prospectus requirements. As with all securities offered in the exempt market, MICs are distributed primarily by way of an offering memorandum (OM) and may only be purchased by certain investors who qualify for exemption (e.g. accredited investor exemption, eligible investor under the offering memorandum exemption, etc.).

You should thoroughly review the offering documents (offering memorandum) as a matter of your due diligence obligations.

REGISTRATION

CSA Staff Notice 31-323 establishes requirements with respect to mortgage investment entities (MIEs) including MICs. Pursuant to the notice, all mortgage investment entities (MIEs) which invest in a pool of mortgages (Pooled MIEs) in Alberta are considered investment funds. As such, all Pooled MIEs in Alberta must become registered as an investment fund manager.

For all other jurisdictions, CSA Staff Notice 31-323 establishes requirements which include:

- the definition of a mortgage investment entity (MIE):
  - company whose purpose is to invest substantially all of its assets in mortgages
  - other assets are limited to certain types of assets (deposits, cash, specified debt, etc.)
- the requirement for certain pooled MIEs to become registered as an investment fund manager where:
  - the Pooled MIE does not take an active role in originating the mortgages that become part of the investment portfolio, and
  - the Pooled MIE buys or sells mortgages in accordance with a stated portfolio investment strategy.

TAX CONSIDERATIONS

The tax considerations of any investment should be determined in consultation with a professional tax adviser. For information purposes, the general tax considerations in relation to MICs are outlined below.

INCOME

MICs are flow-through investment vehicles and must distribute 100% of net income before tax to shareholders. The dividends distributed by a MIC to its shareholders are taxed as interest income, in the hands of the shareholder.

CAPITAL GAINS

MICs may also flow capital gains to its shareholders. Capital gains distributed must be treated as capital gains of the shareholders and the taxable capital gains must be computed (currently at 50%) and reported in the shareholders' tax filings.

DISPOSITION

Where a shareholder disposes of their MIC shares, they must calculate their adjusted-cost base and capital gain or loss and report the taxable amounts in their tax filing.

REGISTERED PLAN ELIGIBILITY AND TFSAs

Most MICs are eligible for registered plans such as RRSPs, RRIFs, TFSAs, RESPs, and RDSPs.

BENEFITS OF MORTGAGE INVESTMENT CORPORATIONS

Mortgage investment corporations can provide the following benefits:

- **Potential for attractive yields:** The interest rates charged to the borrowers of MICs are typically higher than market rates, thus resulting in attractive yields.
- **Managed investment product:** MICs are commonly diversified, professionally managed portfolios.
- **Asset-backed investment:** MICs are mortgage pools and the underlying mortgages are secured against real property.
- **Registered Plans:** Most MICs are eligible for registered plans such as RRSPs, RRIFs, TFSAs, RESPs, and RDSPs.
- **Income stream:** MIC investors receive dividend payments funded by the income generated from the mortgage pool's mortgage payments and mortgage fees; the income stream can typically be predictable.
- **Redemption feature:** Most MICs can be redeemed on a periodic basis (e.g. monthly redemptions) as established in the offering documents (offering memorandum) for the MIC

FEES AND EXPENSES

The fees and expenses may vary from one MIC to another. You must read the offering memorandum to ascertain the fees and expenses which will apply to any MIC. Broadly speaking, the fees and expenses associated with a MIC include:

- **Sales Commissions:** EMDs are usually entitled to a sales commission expressed as a percentage of the subscription price (e.g. 7%)
- **Management Fees:** The manager of the MIC is usually entitled to management fees which are expressed as a percentage of the net asset value of the MIC. Most MICs pay annual management fees (e.g. 1.8%) and monthly management fees (e.g. 0.15%).
- **Other Fees and Expenses:** Other fees and expenses related to MICs include:

- administration fees
- professional fees
- referral fees
- license/trademark fees

RISK FACTORS

There are certain risks associated with MICs. The most apparent risks commonly associated with MICs are summarized below.

- **Market Risk:** risks from general real estate market conditions, changes in real estate values, declines in the value of real property secured by the mortgages
- **Interest Rate Risk:** risks from fluctuations in interest rates
- **Credit Risk:** the risk of loss arising from defaults (failure to repay) within the pool of assets
- **Prepayment risk**: the risk of loss arising from pre-payments (before maturity) which result in lower interest payments to the MIC
- **Liquidity Risk:** As with other exempt securities, there is no secondary market for MICs and the securities are subject to resale restrictions
- **Retraction Liquidity:** Although MICs often offer a redemption feature, redemptions are subject to retraction periods and there are different retraction periods for different classes of shares. If the investor does not provide the issuer with the appropriate notice of retraction, **the right of retraction is suspended until an additional time period has elapsed**. Commonly, the issuer will not guarantee or provide any assurance that it will be able to retract (i.e. redeem) any shares at any time.
- **Blind Pool Risk:** At the time that investors purchase shares of a MIC, no investment in mortgages will have been made. The investors are effectively investing in a blind pool. This means that capital is raised from investors before the issuer invests in mortgages or reports on the investments in the MIC pool. Blind pools offer few restrictions or safeguards for investor security. The investors are totally dependent on the investment manager to discharge their duties honestly, in good faith, and in the best interests of the shareholders and to invest the MIC's money wisely. It is therefore essential that investors have full confidence in the integrity and capabilities of the investment manager before they invest in a MIC.

Land Development Limited Partnerships

3

CONTENT AREAS

INTRODUCTION

In this lesson, you will learn about land development limited partnerships.

This lesson takes approximately 20 minutes to complete.

LEARNING OBJECTIVES

At the end of this lesson, you will be able to:

1 | Define what a land development limited partnership is.

2 | Describe the characteristics of land development limited partnerships.

3 | Explain the tax considerations of land development limited partnerships.

4 | Discuss the benefits of land development limited partnerships.

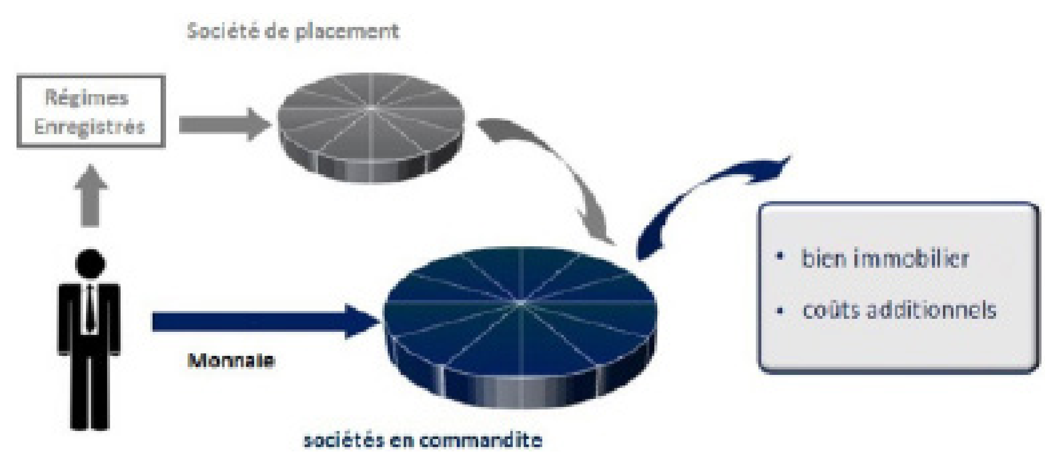
5 | Discuss the fees and expenses of land development limited partnerships.

6 | Explain the risk factors of land development limited partnerships.

WHAT IS A LAND DEVELOPMENT LIMITED PARTNERSHIP?

A land development limited partnership (LP) is a security offered to investors to provide them with the opportunity to invest in land development projects. Most land development LPs are offered under an exemption from prospectus requirements and are distributed in the exempt market. Under the LP, the general partner acts as the manager of the land development project. The limited partners are typically passive investors who buy limited partnership units (LPUs). Many land development LPs also create an investment corporation ("IC") or a trust, complimentary to the LP. The purpose of the IC/trust is to purchase units of the LP and offer shares/units to investors for their registered plans.

Figure 7.3



THE CHARACTERISTICS OF LAND DEVELOPMENT LIMITED PARTNERSHIPS

Land development LPs provide investors with the opportunity to invest in projects in all stages of land development, from undeveloped land to developed real estate. The 5 major stages for land development are summarized in the table below.

Land Development Cycle		
Stage 1	Pre-Development	"Raw" or undeveloped land
Stage 2	Concept Planning	Creation of a development blueprint and rezoning of the land for eventual development
Stage 3	Horizontal Development	Installation of power, pipes, pavement, etc. (servicing)
Stage 4	Vertical Development	Construction of structures
Stage 5	Developed Property	Sale, resale, and rental market

FUNDING MODELS

Land development LPs utilize different funding models in their product structures. The different funding models are:

ALL-CASH

The project allocates a portion of the funds raised up front to:

- segregated reserve accounts for ongoing administrative and planning expenses
- general costs of the company (i.e. overhead)
- costs of the investment product (e.g. sales commissions)
- interest, taxes, depreciation, and amortization

LEVERAGED

The project allocates the majority of the funds raised to purchase the property. The project is then leveraged against the acquisition of another property or alternate financing is secured that must be repaid on a scheduled basis. This funding model increases the risk to investors should the company not be able to cover the costs of the loans or if it defaults on one property secured against another property.

You should be fully aware of the LPs funding model as a matter of your due diligence obligations.

EXIT STRATEGY

The exit strategy for a land development LP is a critical consideration so that investors can realize a return. In land development LPs, the exit strategy involves the sale of the property or a restructuring arrangement so that the land investment LP is exited and structured into a new investment, often with a new set of investors or another end user. You should be fully aware of the LPs exit strategy as a matter of your due diligence obligations.

DISTRIBUTION OF LAND DEVELOPMENT LIMITED PARTNERSHIPS

As with all securities offered in the exempt market, land development LPs are distributed primarily by way of an offering memorandum (OM) and may only be purchased by certain investors who qualify for exemption (e.g. accredited investor exemption, eligible investor under the offering memorandum exemption, etc.).

TAX CONSIDERATIONS

The tax considerations of any investment should be determined in consultation with a professional tax adviser. For information purposes, the general tax considerations in relation to land development LPs are outlined below.

LAND HELD AND SOLD AS INVENTORY IS CONSIDERED INCOME

Firms in the business of buying and selling land or offering land development as an investment opportunity generally consider their assets as inventory and, as a result, profits are taxed as income, not capital gains. Though this may sound strange at first, there is a simple explanation as demonstrated in the example below.

EXAMPLE

A convenience store buys a refrigerator for the purpose of chilling its bottled drinks. The drinks they sell are part of their inventory. Proceeds from their drink sales are therefore considered income.

The store sells the refrigerator 3 years later for more than they purchased it for. Is it a capital gain or income? Since the store purchased the refrigerator for the purpose of housing drinks and not for the purpose of selling it later for profit, it is seen as a capital asset, not inventory. It is therefore taxed as a capital gain. If the store entered the business of buying and selling refrigerators for the purpose of making a profit, the refrigerators they purchase would then be seen as inventory and would be taxed as income. That is also why gains on your primary residence are taxed as capital gains, while real estate that is only bought and sold for the purpose of making a profit is usually taxed as income.

As with all other limited partnerships, the income of the partnership and the tax owed on that income is allocated to the limited partners (i.e. the unit holders). The unit holders receive the income generated by the limited partnership in its original form (i.e. as income) and then must report the income in their tax filings. The land development LP is required to file Form T5013 (Partnership Information Return) with the CRA and must also issue tax slips to its limited partners. The unit holders of the LP must report the income declared on the tax slips received from the LP in their respective tax filings.

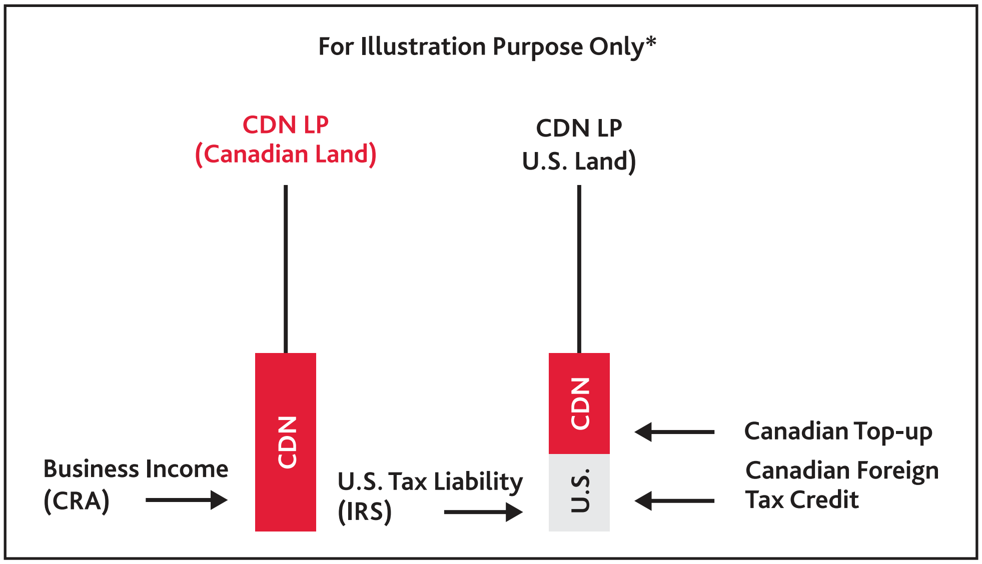
LIMITED PARTNERSHIP AND INVESTMENT CORPORATION STRUCTURE

After exit, land development LPs distribute the cash exit proceeds to investors. When there is an investment corporation (IC) or a trust, the IC/trust also receives a cash distribution from the LP upon exit. Where there is an IC, the IC is obligated to pay taxes at the corporate level and then pay the after-tax income to the IC investors (i.e. to the registered plans of the IC investors).

TAX ON LAND DEVELOPMENT IN THE UNITED STATES

In some cases, land development LPs will invest in properties in the United States (U.S.). When the exit of a land development project in the U.S. results in a distribution to a Canadian investor, a U.S. tax obligation generally applies. In order for Canadian investors to file U.S. taxes, they must first obtain an Individual Taxpayer Identification Number (ITIN) from the Internal Revenue Service (IRS). An ITIN application (Form W-7) can be obtained from the IRS website. Canadian residents who invest in a Canadian LP that deals in U.S. land will be subject to U.S. taxation, but will generally not pay more than their Canadian effective marginal income tax rate due to tax treaties between Canada and the U.S. The diagram below illustrates the U.S. withholding tax obligations and the Canadian tax credit that applies.

Figure 7.4



REGISTERED PLAN ELIGIBILITY AND TFSAs

When a land development LP is structured with an IC or a trust, it may be eligible for many types of Canadian registered plans including RRSPs and TFSAs.

BENEFITS OF LAND DEVELOPMENT LIMITED PARTNERSHIPS

Land development LPs can provide the following benefits:

- **Potential for attractive returns:** For investors who can endure a high degree of risk, limited liquidity, and an extended duration to exit, land development LPs have the potential to provide attractive returns.
- **Managed investment product:** Land development LPs are commonly diversified, professionally managed portfolios.
- **Asset-backed investment:** Properly managed land development LPs hold properties with real value.
- **Access:** The investment structure allows retail investors who qualify for exemption (e.g. accredited investors, eligible investors, etc.) to participate in land development opportunities which they would not otherwise have access to.

FEES AND EXPENSES

The fees and expenses may vary from one land development LP to another. You must read the offering memorandum to ascertain the fees and expenses which will apply to any land development LP. Broadly speaking, the fees and expenses associated with a land development LP include:

- **Sales Commissions:** EMDs are usually entitled to a sales commission expressed as a percentage of the subscription price (e.g. 7%)
- **Expenses of the Offering:** The expenses of the offering include:
  - the costs of organizing the LP

  - the costs of printing and preparing the prospectus or offering memorandum
  - legal expenses of the LP and the general partner
  - marketing expenses
  - other costs incurred by the general partner and the selling group of dealers

- **Management Fees:** The manager of the LP is usually entitled to a management fee which is expressed as an annual percentage of the net asset value of the LP (e.g. 2%)
- **Performance Fees:** The manager may also be entitled to a performance bonus in addition to the management fees
- **Other Fees and Expenses:** Other fees and expenses related to land development LPs include:
  - company overhead
  - research costs
  - structuring and legal costs
  - planning and approval costs
  - development costs
  - loan interest payments
  - ongoing project administrative expenses

Commonly, the commissions, fees, and expenses for land development LPs are taken up front, included in the offering price to the investor, and contributed to a reserve fund which funds the payments. Land investment and development costs are usually very capital intensive and, as such, costs and expenses paid from the reserve fund can be substantial.

RISK FACTORS

There are certain risks associated with land development LPs. These risks vary depending on the way the investment is structured and how it is financed. The most apparent risks commonly associated with land development LPs are summarized below.

- **Duration:** Land development investments can take a substantial length of time and many such investments offer no timing guarantees or maturity dates.
- **Liquidity:** Typically, land development LPs are not liquid, there is no secondary market, and securities regulations restrict the resale of the securities.
- **Entitlement:** When land is acquired without full development approvals or entitlements, there is a risk that approvals cannot be achieved or that they may take more time than some investors can withstand.
- **Environmental Risk:** Federal and provincial laws apply with respect to liability concerning environmental issues.
- **Leverage:** In some cases, land development LPs leverage properties against the acquisition of other properties. This model increases the risk to investors where there is a default on one property secured against another property. Land development LPs that are highly leveraged or fail to set aside sufficient cash reserves will have increased risk associated with the investment.
- **Management:** The success of the LP, to a large extent, depends on the good faith, experience, ability, and judgment of the general partner and management.
- **Market Risk:** Unfavorable real estate market conditions or general economic conditions can have a negative impact on the performance of a land-based investment.

- **Blind Pool Risk:** At the time that investors subscribe for units of a land development LP, no investment in properties will have been made. The investors are effectively investing in a blind pool. This means that capital is raised from investors before the issuer invests in assets or reports on investments in the portfolio. Blind pools offer few restrictions or safeguards for investor security. The investors are totally dependent on the general partner and investment manager to discharge their duties honestly, in good faith, and in the best interests of the limited partners and to invest the LP's money wisely. It is therefore essential that investors have full confidence in the integrity and capabilities of the general partner and investment manager before they invest in a land development LP.

UNIT SUMMARY

Congratulations, you have reached the end of Unit 7: Real Estate and Mortgage Investments.

In this unit you covered:

- Lesson 1: Real Estate Investment Trusts
- Lesson 2: Mortgage Investment Corporations
- Lesson 3: Land Development Limited Partnerships

Now that you have completed these lessons, you are ready to assess your knowledge with a 10-question quiz. To start the quiz, return to the IFSE Landing Page and click on the Unit 7 Quiz button.

UNIT 8

FLOW-THROUGH SHARES

INTRODUCTION

In this unit you will learn about flow-through shares.

This unit takes approximately 1 hour and 40 minutes to complete.

Lessons in this unit:

1. Characteristics of Flow-Through Shares
2. Tax Considerations of Flow-Through Shares
3. The Benefits of Flow-Through Shares
4. Fees and Expenses of Flow-Through Limited Partnerships
5. Risk Factors of Flow-Through Limited Partnerships

Characteristics of Flow-Through Shares

1

CONTENT AREAS

INTRODUCTION

In this lesson, you will learn about the characteristics of flow-through shares.

This lesson takes approximately 30 minutes to complete.

LEARNING OBJECTIVES

At the end of this lesson, you will be able to:

1 | Define a flow-through share.

2 | Define a principal-business corporation (PBC).

3 | Define Canadian exploration expense (CEE).

4 | Define Canadian development expense (CDE).

5 | Explain the difference in the tax treatment of CEE and CDE.

6 | Describe the federal and provincial tax credits on flow-through shares.

7 | Describe the key considerations when investing directly in an issuer.

8 | Describe the characteristics of flow-through limited partnerships.

9 | Discuss the distribution of flow-through shares.

WHAT IS A FLOW-THROUGH SHARE?

In order to encourage investment in the exploration and development of natural resources, the federal government has designated certain companies as principal-business corporations (PBCs). PBCs are companies in the resource sector including oil and gas, mining, renewable energy, and energy conservation. These PBCs are permitted to issue flow-through shares.

A flow-through share (FTS) is a special kind of share issued by a PBC to a shareholder under an agreement which specifies that eligible exploration and development expenses of the PCB will be "renounced" by the corporation to the shareholder. Since large expenditures are usually involved in resource exploration and development, the PBC would typically have little revenue to offset the expenses against, thus the tax deductions could not be used. By issuing flow-through shares, the PBC is able to monetize the tax deductions they cannot use. In turn, the shareholder can deduct the expenses from their other sources of income, thereby reducing their income taxes payable.

EXAMPLE

Jim subscribes for flow-through shares of a resource company in the amount of $100,000. The company uses the subscription proceeds on exploration and development expenses amounting to $100,000 and renounces the expenses to Jim. Jim deducts the renounced expenses of $100,000 as exploration and development expenses in computing his taxable income. Suppose Jim pays tax at a marginal rate of 46%. The tax saving is $46,000 or ($100,000 × 46%).

A flow-through share is a new share of capital stock of a PBC that:

- is not a prescribed share, and
- is issued to a shareholder pursuant to a flow-through share agreement.

FLOW-THROUGH SHARE AGREEMENT

A flow-through share agreement is a written agreement between an investor and a flow-through issuer which specifies that:

- the issuer will incur Canadian exploration expense (CEE) or Canadian development expense (CDE) and the amount of CEE or CDE will not be less than the value of the flow-through shares
- the issuer will renounce to the investor amounts of CEE or CDE that are not more than the value of the flow-through shares

The expenses must be incurred within 24 months following the month the agreement is entered into.

FLOW-THROUGH WARRANTS

Holders of flow-through warrants have a right to require flow-through shares to be issued to them. When large investors purchase flow-through shares of PBCs, they are sometimes in a position to negotiate flow-through warrants at no additional cost. This has the potential to increase the return on their investment.

FLOW-THROUGH INVESTORS

Individuals, trusts, corporations, and partnerships can purchase flow-through shares, but only the original investors in flow-through shares may have amounts renounced to them.

PBC EXPENSES RENOUNCED IN FLOW-THROUGH SHARES

CANADIAN EXPLORATION EXPENSE AND CANADIAN DEVELOPMENT EXPENSE

A PBC may renounce the following types of expenses to its initial investors:

- Canadian exploration expense (CEE)
- Canadian development expense (CDE)

When CEE and CDE are renounced to an investor, they are added to the investor's cumulative CEE pool and cumulative CDE pool. Summarized in the table below are the parameters which apply to CEE and CDE deductions.

Canadian Exploration Expense (CEE) & Canadian Development Expense (CDE)		
Expense	**What % may be deducted**	**What expenses are included**
Canadian Exploration Expense (CEE)	• up to 100% of the balance in a cumulative CEE pool may be deducted in a year	Includes certain expenses incurred to: • determine the existence, location, extent, or quality of a mineral resource or of an accumulation of petroleum or natural gas in Canada • bring into production a natural accumulation of petroleum or natural gas in Canada, or a new mine in a mineral resource in Canada
Canadian Development Expense (CDE)	• the maximum percentage deductible in a cumulative CDE pool is 30% in a year • any balance not deducted may be carried forward indefinitely and deducted in future years.	Includes certain expenses incurred for the development of: • an oil or gas well in Canada • a mine in Canada

LOOK-BACK RULE

Under the "look-back" rule, an issuer may renounce expenditures that it will incur in Year 2 with an effective date of renunciation of December 31 of Year 1. The date of renunciation must be before April of Year 2. The look-back rule is only available where the flow-through shares are structured as a limited partnership that deals at arm's length with the issuer.

SUPER FLOW-THROUGH SHARES AND INVESTMENT TAX CREDITS

Individual investors (excluding trusts) who are the initial purchasers of flow-through shares may also claim a 15% non-refundable investment tax credit (ITC) on certain CEE expenses renounced to the investors. Flow-through shares which entitle their holders to the 15% federal ITC are commonly known as super flow-through shares.

The ITC may be used to reduce the federal income tax payable by a limited partner who is an individual other than a trust. ITCs can be carried back three years, and forward 20 years.

The following provinces offer provincial tax credits:

- British Columbia – Mining Flow-Through Share Tax Credit
- Manitoba – Mineral Exploration Tax Credit
- Ontario – Focused Flow-Through Share Tax Credit

The provincial tax credits reduce the amount of CEE qualifying for the federal tax credit. They apply only to eligible expenditures in the applicable province, and only to residents of that province.

INVESTING IN FLOW-THROUGH SHARES

Investors may invest in flow-through shares in two different ways:

- purchase shares from an issuer directly
- purchase limited partnership units that purchases flow-through shares from a number of issuers

DIRECT INVESTMENT IN AN ISSUER

Investing directly in flow-through shares of an issuer exposes the investor to the risks inherent in investing in a single issuer in a cyclical industry. Therefore, due diligence would involve a thorough examination of the issuer to evaluate its merits as an investment. In your due diligence assessment, you should consider:

- the risks of investing in the resource sector generally
- the factors specific to the issuer

When analyzing the factors specific to a resource company, due diligence should involve, at minimum, a thorough examination of the factors summarized in the table below.

Due Diligence of the Resource Company	
Management Team	• What is the breadth of the company's management team? • What is the depth of the management team, particularly its experience in the resource sector?
Resource Company	• What is the company's track record? • Is there a solid exploration program in place? • Does the company have joint ventures or other relationships with major resource companies? • What is the potential for future growth?
Resource Properties	• Does the company have a solid base of properties? • What is the geographic diversification of its properties? • Does the company have good title to its properties?
Offering Price	• Is the offering price fair? Consider factors such as: ◦ the company's past production results ◦ its past exploration results ◦ its potential for future growth ◦ the level of its overhead costs ◦ its existing and potential land inventory ◦ the strength of its balance sheet ◦ the liquidity of its shares ◦ any resale restrictions on the shares ◦ the prices of the shares of comparable companies

FLOW-THROUGH LIMITED PARTNERSHIPS

The majority of flow-through shares are issued through private placements structured as limited partnerships. The limited partnership (LP) most commonly invests in the flow-through shares of many issuers. This approach has two main advantages:

- diversification
- professional management

The objectives of a flow-through LP include:

- tax-assisted investment
- diversification
- investment in resource exploration and development
- capital appreciation

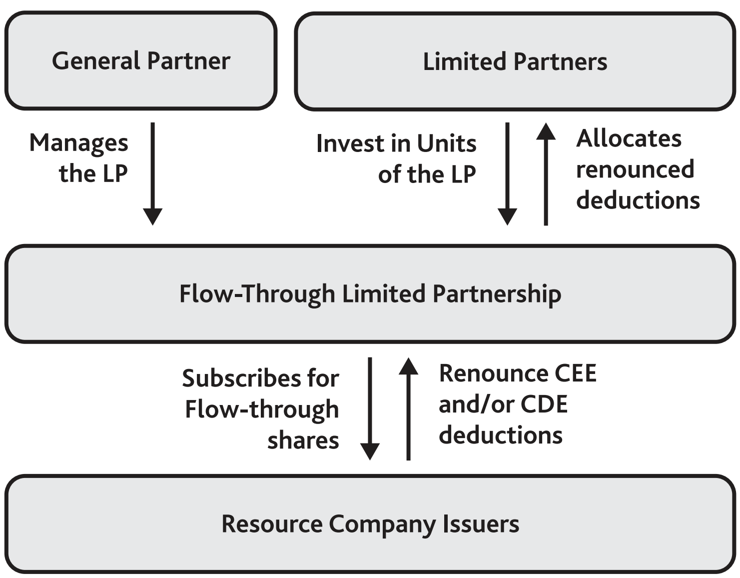
THE STRUCTURE OF FLOW-THROUGH LIMITED PARTNERSHIPS

Flow-through LPs are diversified portfolios which are structured as limited partnerships. The money pooled from the limited partners (unit holders) in the LP is used to purchase flow-through shares of the resource companies. The CEE and CDE deductions are renounced to the LP. The LP allocates the renounced CEE and CDE deductions to the LP unit holders.

The diagram below illustrates the structure of a flow-through LP.

Figure 8.1

Structure of a Flow-Through Limited Partnership



DUE DILIGENCE CONSIDERATIONS WITH FLOW-THROUGH LPS

Due diligence of a flow-through LP would involve a thorough examination of the LP to evaluate its merits as an investment. In your due diligence assessment, you should consider:

- the risks of investing in the resource sector generally
- the factors specific to the issuer

When analyzing the factors specific to a flow-through LP, due diligence should involve, at minimum, a thorough examination of the factors summarized in the table below.

<table>
<tr><th colspan="2">Due Diligence of the Flow-Through LP</th></tr>
<tr><td>Manager</td><td>You must be absolutely confident in the integrity and competence of the manager. Important factors include:
the manager's reputation for integrity
experience
experience in flow-through LPs
track record
size as measured by its assets under management
investment management, risk management, compliance, and administration capabilities
registration (under NI 31-103, investment fund managers are required to be registered with the securities commissions)</td></tr>
<tr><td>Tax Shelter Identification Numbers</td><td>CRA and provincial tax authorities issue tax shelter identification numbers and these must be included in every tax return the investor files (the tax shelter identification number does not constitute confirmation that the investor is entitled to claim any deductions)</td></tr>
<tr><td>Investment Objectives</td><td>investment objectives of the LP
criteria for portfolio diversification
proposed mix of junior and senior companies</td></tr>
<tr><td>Borrowing by the LP</td><td>The LP may borrow in order to invest in flow-through shares of issuers. If so, determine the:
maximum leverage allowed
terms of the borrowing, interest rate, fees, expenses
recourse for borrowing</td></tr>
<tr><td>Size of Offering</td><td>Minimum and maximum number of units that may be issued
The offering size is important for many reasons including:
some of the costs associated with an offering are fixed, the smaller the offering, the heavier the fixed costs relative to the size of the offering
an offering which is too small may not allow for adequate diversification or scope of investment opportunities
an offering which is too large may not be able to find sufficient investment opportunities for the entire offering and the LP would return a portion of the subscription price back to the unit holders</td></tr>
<tr><td>Offering Particulars</td><td>offering price
minimum subscription (e.g. $5,000.00 or more)
offering period: offered during the selling period only, typically 2 to 4 months
closing: typically conditional on selling a minimum number of units</td></tr>
</table>

ABSENCE OF A SECONDARY MARKET

Even when flow-through LPs are distributed under a prospectus, their units are not usually listed on an exchange or traded on a public market. This actually has positive tax consequences. Because the LP's units are not publicly traded, it is not subject to the specified investment flow-through rules (SIFT Rules). Under those rules, which apply to certain publicly-traded income trusts and LPs, certain amounts earned and distributed by the applicable entities are subject to tax.

The absence of a secondary market makes it difficult for investors to sell their units. An investment in a flow-through LP should only be considered by investors who do not require liquidity during the term of the LP.

ABSENCE OF CASH DISTRIBUTIONS

While some LPs make cash distributions to their limited partners, the distributions are usually small and are subject to various factors, including the availability of cash. Consequently, investors should not rely on cash distributions from the LP to discharge the tax liability on amounts of income or capital gains which are allocated to them by the LP. Nor should investors rely on cash distributions to service the interest payments and principal repayment of any loans contracted by them to purchase LP units. Investors should ensure that they have the means to finance these payments from sources other than cash distributions from the LP.

MUTUAL FUND ROLLOVER EVENT

At the end of the term of a flow-through LP, the limited partners may receive units of a mutual fund in exchange for their LP units. At that point, investors may wish to redeem the mutual fund units and exit the investment. Redemption is necessary if the investor wants to adopt a strategy of recycling the tax savings. You should review the investment objectives and portfolio of the mutual fund and ensure that it holds sufficient investments in liquid securities to be able to meet the redemption proceeds.

DISTRIBUTION OF FLOW-THROUGH SHARES

Issuers offer flow-through shares in one of two ways:

- a public offering under a prospectus
- a private placement under an exemption from prospectus requirements

Unlike other public securities offered by prospectus, such as common shares, investors cannot sell, trade, or redeem their flow-through shares on any market. Regardless of whether the flow-through shares are issued as a public offering or a private placement, there is no trading or liquidity in the shares until the "liquidity event", prescribed in the offering documents, occurs. The liquidity event constitutes a point when the flow-through shares "rollover" and convert into an open-end mutual fund. While the mutual fund will provide a redemption feature, between the time the flow-through shares are purchased and the mutual fund rollover, the flow-through shares are not tradable. This, in large part, is derivative of the tax flow-through features of the security. Similar to other public securities offered by prospectus, public flow-through shares are subject to prospectus filing and continuous disclosure requirements.

Many issuers offer flow-through shares as private placements under an exemption from prospectus requirements. As with all securities offered in the exempt market, flow-through limited partnerships are distributed primarily by way of an offering memorandum (OM) and may only be purchased by certain investors who qualify for exemption (e.g. accredited investor exemption, eligible investor under the offering memorandum exemption, etc.).

You should thoroughly review the offering documents (offering memorandum) as a matter of your due diligence obligations.

Tax Considerations of Flow-Through Shares

2

CONTENT AREAS

Calculating the Canadian Exploration Expenses (CEE) Deductions
Calculating Capital Gains
Calculating the Net Tax Benefit
Limitations on the Deductibility of CEE
Québec Residents
Calculating Deductions using Cumulative CEE and CDE Pools
Tax Deferral
Other Tax Deduction Considerations

INTRODUCTION

In this lesson, you will learn about the tax considerations of flow-through shares.

This lesson takes approximately 30 minutes to complete.

LEARNING OBJECTIVES

At the end of this lesson, you will be able to:

1 | Calculate the deduction for CEE.

2 | Calculate the capital gains on flow-through shares.

3 | Calculate and understand the net tax benefit and break-even point.

4 | Discuss the limitations of the deductibility of CEE.

5 | Discuss the tax benefits to Québec Residents.

6 | Explain the cumulative CEE and CDE pools.

7 | Explain the way flow-through shares offer tax deferral and the benefits.

8 | Discuss the other tax considerations related to flow-through shares.

CALCULATING THE CANADIAN EXPLORATION EXPENSES (CEE) DEDUCTIONS

Unit holders of a flow-through LP may deduct from their income an amount equal to 100% of the CEE renounced to them. The amount of the tax deduction depends on the taxpayer's marginal tax rate as illustrated in the example below.

EXAMPLE

Wendy invests $10,000 in units of a flow-through LP. CEE totaling $10,000 is allocated to her in the same year. Wendy's marginal tax rate is 46%.

Initial investment	$10,000
CEE deduction × marginal tax rate ($10,000 × 46%)	**$4,600**

The two assumptions made in this example are:

- In the year of the investment into the flow-through LP, the amount of the deduction for CEE is equal to the cost of the investment. In practice, the amount of the deduction in the first year will usually lie in the range of 90% to 100%, with the balance being deductible in future years.
- The investor has sufficient taxable income to use the deduction.

CALCULATING CAPITAL GAINS

Unit holders of a flow-through LP will be required to include capital gains in their tax filings. In calculating the adjusted cost base (ACB) of the flow-through LP unit (LPU), the LPU is deemed to have an ACB of zero when purchased. The ACB is zero even if the amount of renounced expenses is less than the cost of the investment. Indeed, even if no resource expenses at all are renounced, the ACB is still zero. The effect of this rule can be punitive.

EXAMPLE

Suppose Samuel is the initial purchaser of flow-through shares with a cost of $200,000. The issuer does not renounce resource expenses to the investor. After a year, Samuel sells the flow-through shares for the same price of $200,000. Since the ACB of the shares is zero, he realizes a capital gain of $200,000, half of which is taxable. Samuel has not benefited from any tax deduction but is required to pay tax on a capital gain which exists only for tax purposes.

ADJUSTED COST BASE (ACB) OF A FLOW-THROUGH LIMITED PARTNERSHIP UNIT (LPU)

The ACB of a flow-through LPU is calculated as shown in the formula below.

Formula: ACB of a Flow-Through LPU

A + (B – C – D) = E

Where:

A = the subscription price paid for the unit, plus

B = any share of income allocated to the unit holder, less

C = any share of losses and CEE allocated to the unit holder, less

D = the amount of any cash distributions made to the unit holder

E = Adjusted Cost Base (ACB)

As a result of the application of this formula, the ACB of a flow-through LPU is generally zero or minimal. If the ACB becomes less than zero, the amount of any negative ACB is deemed to be a capital gain of the unit holder in the year in which the ACB becomes negative.

ADJUSTED COST BASE (ACB) OF UNITS OF THE ROLLOVER MUTUAL FUND

At the end of the LP's term, the units of the flow-through LP are converted to units of an open-end mutual fund. The "rollover" to the mutual fund takes place on a tax-deferred basis. The ACB of the mutual fund units is equal to the ACB of the LP units, i.e. zero or minimal. When the investor redeems his mutual fund units, the entire redemption proceeds, net of any costs of disposition, constitute a taxable gain, half of which must be included in taxable income.

EXAMPLE

Wendy invests $10,000 in units of a flow-through LP. CEE totalling $10,000 is allocated to her in the same year. After the mutual fund rollover, Wendy redeems the mutual fund units for $10,000. Wendy's marginal tax *rate is 46%*.

Initial investment	$10,000
CEE	$10,000
ACB of flow-through LPU	0
ACB of mutual fund units	0
Redemption of mutual fund units	$10,000
Capital Gain ($10,000 – 0)	$10,000
Taxable Amount of Capital Gain $10,000 × 50%)	$5,000
Tax Payable ($5,000 × 46%)	$2,300

CALCULATING THE NET TAX BENEFIT

Calculating the net tax benefit considers the CEE deduction from the flow-through LPUs and the capital gain on disposition of the rollover mutual fund units.

Formula: Net Tax Benefit

A – B = C

Where:

A = CEE tax deduction

B = tax payable on the capital gain

C = Net Tax Benefit

EXAMPLE

Using the same example as for the CEE and capital gain for Wendy who invests $10,000 in units of a flow-through LP and redeems the mutual fund units for $10,000.

CEE deduction × marginal tax rate ($10,000 × 46%)	$4,600
Tax payable on taxable capital gain ($5,000 × 46%)	($2,300)
Net Tax Benefit	**$2,300**

The taxpayer also benefits from the time value of money. The initial tax saving arises when they invest in the flow-through LPUs. On the other hand, the tax on the capital gain only arises on the redemption of the mutual fund units approximately two years later.

The net tax benefit depends on the investor's marginal tax rate. It is highest for an investor who pays the top marginal income tax rate.

CALCULATING THE BREAK-EVEN POINT

An important concept in flow-through investing is the break-even point. Because of the net tax benefit, it is possible for the investment in the flow-through LP to lose value without the investor losing any money. The break-even point indicates the value of the investment at which point there is no profit or loss to the investor.

Formula: Break-Even Point

A – B = C

Where:

A = Initial investment

B = Net Tax Benefit

C = Break Even Point

EXAMPLE

Continuing from the same example for the CEE, capital gain, and net tax benefit for Wendy, the break-even point is $7,700.

Initial investment	$10,000
Net Tax Benefit	($2,300)
Break-Even Point	**$7,700**

The investment loss for the break-even point is $2,300.

Redemption proceeds at break-even point	$7,700
Initial investment	$10,000
Investment Loss	**($2,300)**

In the example above, when the value of the investment drops to $7,700, the investment loss is exactly offset by the net tax savings, and the investor makes neither a profit nor a loss. In other words, the value of the investment can drop by as much as $2,300 or ($10,000 – $7,700) without the investor losing any money. This corresponds to a drop of 23% in the initial value of the investment.

The above analysis does not take any Investment Tax Credits (ITCs) into account. The break-even point will be even lower if ITCs are available.

LIMITATIONS ON THE DEDUCTIBILITY OF CEE

It is important to note that the tax deductions for flow-through shares are subject to certain provisions and rules in the Tax Act which may restrict the ability of a unit holder to deduct certain expenses and losses. These rules include the:

- at-risk rule
- tax shelter investment rule on limited recourse debt

Both the at-risk rule and the tax shelter investment rule on limited recourse debt may reduce the expenditures of the unit holder by the limited recourse amounts or the at-risk amounts. Both rules consider amounts borrowed by the unit holder in order to invest in the flow-through shares. To ensure that their limited partners do not fall foul of the tax shelter investment rules, flow-through LPs sometimes make arrangements with financial institutions to make available to their investors loans which meet the required conditions. An investor who finances the purchase of flow-through LPUs by means of a loan should make sure that recourse for the loan is not, and is not deemed to be, limited (e.g. a limited amount of the principal is secured, etc.).

QUÉBEC RESIDENTS

Special considerations exist under the Tax Act for Québec.

- Individual residents in Québec may be entitled, for Québec income tax purposes, to a deduction of up to 150% of certain eligible exploration expenses incurred in Québec by a qualifying entity. This will increase the value of the tax deduction.
- For Québec income tax purposes, the investor may also be exempted from tax on the portion of the capital gain represented by the difference between the purchase price of the flow-through share and the ACB of zero. Rather, the profit on the difference between the sale proceeds and the purchase price is treated as a capital gain.
- For Québec income tax purposes, the investment expenses incurred by an individual taxpayer in a given taxation year must be compared with the investment income earned for that year. For this purpose, investment expenses include certain deductible interest and losses of the taxpayer and 50% of CEE incurred outside Québec and deducted for Québec income tax purposes. Investment income includes taxable capital gains not eligible for the capital gains exemption.

  If the investment expenses exceed the investment income, the excess is included in the taxpayer's income, thereby offsetting the deduction for that portion of the investment expenses.

  The portion of the investment expenses, including any CEE, which has been included in the taxpayer's income in a given taxation year may be carried back and applied against net investment income earned in any of the three previous years or carried forward and applied against net investment income in any subsequent taxation year.

The first two considerations will lower the break-even point for a taxpayer who is a resident of Québec. On the other hand, if the taxpayer is unable to deduct the CEE fully as a result of the third consideration, the break-even point will be increased.

CALCULATING DEDUCTIONS USING CUMULATIVE CEE AND CDE POOLS

CEE and CDE renounced to a unit holder by an issuer during a year are not deducted directly from the taxpayer's income. Instead, they are added to the taxpayer's cumulative CEE and CDE pools. The taxpayer reports the accumulation and depletion of CEE and CDE on CRA Form T1229.

The amount of CEE and CDE which may be claimed as a deduction for the year is:

- **CEE:** 100% of the balance available as calculated on CRA Form T1229
- **CDE:** 30% of the balance available as calculated on CRA Form T1229

Any unclaimed amounts may be carried forward to future years indefinitely. Generally, a taxpayer will continue to be entitled to deduct amounts from his cumulative CEE and CDE pools even if they sell their units of the limited partnership or the rollover mutual fund.

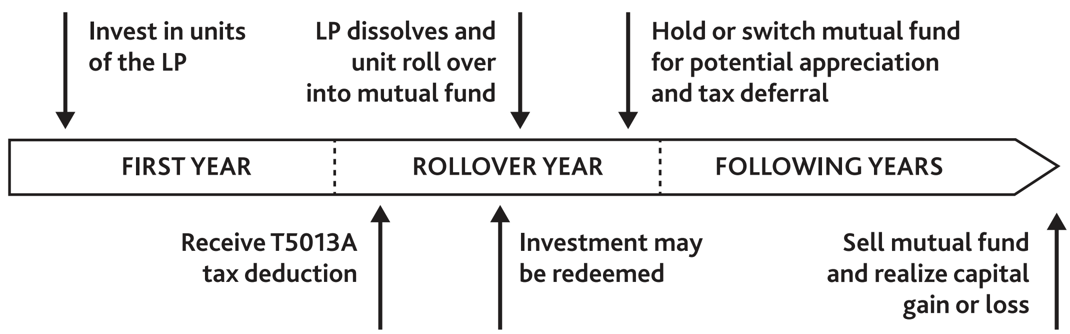
TAX DEFERRAL

The timing of the CEE and CDE tax deductions and the subsequent realization of capital gains allows for tax deferral. This is an additional tax advantage because for most taxpayers it is better to pay taxes in the future, especially if the investor enters a lower tax bracket in future years.

The timeline of a flow-through LP typically runs two years, although investors may hold their rollover units indefinitely. In Year 1, the investment gives rise to a tax refund. In Year 2, capital gains taxes are deferred until eventual disposition. It is the timing of these cash flows that allows for tax deferral and an enhanced internal rate of return (IRR).

Figure 8.2

Timeline of an investment in a Flow-Through Limited Partnership



OTHER TAX DEDUCTION CONSIDERATIONS

CAPITAL LOSSES AND INCOME

LP unit holders will be allocated their pro rata share of capital losses and income of the LP in the fiscal year and those amounts must be reported in their tax filings.

TAXABLE CAPITAL GAINS

The income of the LP includes the taxable portion of any capital gain that it realizes on the disposition of flow-through shares in its portfolio. The ACB of the flow-through shares is deemed to be nil. Consequently, the amount of capital gains will generally be equal to the proceeds of disposition of the flow-through shares, less costs of disposition.

FEES AND EXPENSES OF THE INITIAL OFFERING

The fees and expenses of the initial offering are an expense of the LP. Some flow-through LPs finance the fees and expenses of the initial offering by means of a loan. The outstanding principal and interest on the loan constitutes a limited-recourse amount of the LP. Limited-recourse amounts have adverse tax consequences. The fees and expenses are not deductible in computing the LP's taxable income until the borrowed amount is repaid. 20% of the amount repaid is deductible in the year of repayment and 20% in each of the next four years. The LP is not entitled to deduct any amount in respect of the fees and expenses in the fiscal year ending on its dissolution.

After the dissolution of the LP, any person who was a limited partner immediately prior to the dissolution may deduct in a taxation year ending after that time their pro rata share of the amount which the LP would have been entitled to deduct if it had continued to exist. The adjusted cost base of the LP units will be reduced on dissolution of the LP by their share of that amount.

MANAGEMENT FEES AND OPERATING COSTS

The annual management fees and operating costs are expenses of the LP. Unit holders are allocated their pro rata share of the expenses.

REGISTERED PLAN ELIGIBILITY AND TFSAS

Flow-through LPUs are not eligible to be held within registered plans such as RRSPs, RRIFs, TFSAs, RESPs, and RDSPs. Given the tax deductions, an investment in a flow-through LP has some similarity to a contribution to an RRSP. However, any amount withdrawn from an RRSP is taxable as income whereas disposition of rollover mutual fund units gives rise to a taxable capital gain.

SIFT RULES

Even when flow-through LPs are publicly distributed, they are not listed or traded on a stock exchange or other public market. Consequently, the SIFT Rules do not apply to flow-through LPs.

LEGITIMATE TAX SHELTER

Tax shelters as a group may have a questionable reputation among investors and the CRA. Promoters of tax shelters often operate in grey areas that the CRA later challenges. Should CRA disallow a tax shelter, the investors will face reassessment. However, flow-through investments offer investors a legitimate tax break with tangible tax benefits. Flow-through shares have existed in one form or another since 1954 and the tax deductions and benefits related to flow-through shares have been specifically codified within the Tax Act (Canada) and provincial tax acts.

PROFESSIONAL TAX ADVICE

As with any complex tax-driven investment, investors should consult a qualified tax advisor to determine if the tax benefit is appropriate for them. While the tax advantages of a flow-through investment are important, they should not be an investor's only consideration.

The Benefits of Flow-Through Shares

3

CONTENT AREAS

INTRODUCTION

In this lesson, you will learn about the benefits of flow-through limited partnerships.

This lesson takes approximately 10 minutes to complete.

LEARNING OBJECTIVES

At the end of this lesson, you will be able to:

1 | Summarize the tax benefits of flow-through limited partnerships.

2 | Discuss the other potential benefits of flow-through limited partnerships.

3 | Discuss potential investors for flow-through limited partnerships.

4 | Discuss suitability considerations with respect to flow-through limited partnerships.

5 | Understand the pros and cons of choosing between CEE and CDE investments.

BENEFITS OF FLOW-THROUGH LIMITED PARTNERSHIPS

Flow-through limited partnerships can provide the following benefits:

- **tax benefits:**
  - Canadian Exploration Expense (CEE) and Canadian Development Expense (CDE) tax deductions against income
  - the proceeds on disposition are taxed as capital gains at a favourable rate (currently 50%) and the capital gains may be offset by capital losses from other investments
  - investors are able to recover a large portion of their original investment in tax savings
  - tax savings reduce the investor's break-even point
  - the timing of the tax deduction and the subsequent realization of capital gains allows for tax deferral
  - offers investors a legitimate tax break, with tangible tax benefits which have been specifically codified within the Tax Act (Canada) and provincial tax acts
- **investment:** the opportunity to invest in the natural resource sector at a significantly reduced after-tax cost and the potential for a hedge against inflation and currency devaluation
- **potential long-term capital appreciation:** the potential for appreciation and growth in junior resource companies
- **partial mitigation of down-side market risks:** there is partial mitigation of downside risk since a flow-through investment can show a profit due to the reduced break-even point provided by the tax benefit, even if prices decline
- **managed investment product:** diversified, professionally managed portfolio

POTENTIAL INVESTORS

Investors who might be appropriate for investment in flow-through shares would generally have the following attributes:

- high income
- a need to reduce taxes
- capacity and willingness to tolerate the volatility of investing in speculative junior resource companies

A list of potential candidates for investment in flow-through shares might include:

- High-income earners who are taxable at the highest marginal tax rate, whether due to salary, a one-time bonus, exercise of stock options, etc.
- Investors who want to defer taxes to periods when they will be taxed at a lower rate
- Investors who want to use capital losses or capital loss carry-forwards
- Donors who want to minimize the after-tax cost of a charitable donation
- Business owners who want to shelter their corporation's income

Investors considering a flow-through investment should have a high capacity and tolerance for risk and be comfortable with owning speculative junior resource companies through good times and bad, in the expectation that cyclical returns will average out.

SUITABILITY CONSIDERATIONS

As with any complex tax-driven investment, investors should consult a qualified tax advisor to determine if the tax benefit is appropriate for them. While the tax advantages of a flow-through investment are important, they should not be an investor's only consideration.

The investor's risk profile is a critical factor, in particular their ability to absorb losses and their willingness to invest in speculative junior resource companies. While professionally managed LPs spread risk across a number of individual flow-through shares, volatility in the resource sector can be high and returns are unpredictable. Another important element to consider is liquidity. In the case of a flow-through LP, the investor's capital is locked-in for at least a year, and usually longer. If these conditions are acceptable, a flow-through investment and its worthwhile tax benefits may fit as part of a well-diversified portfolio.

CHOOSING BETWEEN CEE AND CDE FLOW-THROUGH INVESTMENTS

The choice between the two forms of flow-through deduction depends on the investor's personal tax situation and risk profile.

ONE-TIME DEDUCTION VERSUS MULTI-YEAR DEDUCTION

CEE is 100% deductible in the year the expense is incurred. In contrast, CDE is tax-deductible at a rate of 30% on a declining balance basis. For example, 30% is deductible in year one, 21% (30% of 70%) in year two and so on. Therefore, deductions are spread over a longer period of time than those available from CEE.

As a way to stack their CDE deductions, investors may roll over their CDE flow-through investment year after year to accumulate deductions from current and past years. They can also carry deductions forward to high income years.

PREMIUM

Because of the tax benefits granted to CEE flow-through shares, companies issue them at a premium to the market price of the ordinary common shares. Relative to CEE, underwriters of CDE flow-through shares negotiate issue prices with a smaller premium to the market price to reflect the lower demand and the smaller initial tax deduction for CDE flow-through.

RISK

In oil and gas drilling, CDE is incurred to develop proven oil and gas pools with an outcome that is more certain because of the higher quality and quantity of information available on the drilling prospect. In mining, CDE is incurred in sinking a shaft, haulage way, or similar underground work for use in a producing mine. CDE flow-through does not expose investors to the risky exploration activity typical of CEE flow-through investments.

SIZE

Intermediate producers issue CDE flow-through shares to finance production growth. Because they are producing, not just exploring, CDE issuers are typically stronger companies with more robust cash flow and better analyst coverage. Generally, shares of larger issuers also have better trading liquidity and lower business risk.

COMBINING CDE AND CEE UNITS

Combining CDE and CEE is another strategy an investor could consider, for example allocating a percentage to each category.

EXAMPLE

If George combines 70% CDE with 30% CEE flow-through, George can deduct 51% of his total investment in year 1 and the remaining 49% on a declining balance basis.

Fees and Expenses of Flow-Through Limited Partnerships

4

CONTENT AREAS

INTRODUCTION

In this lesson, you will learn about the fees and expenses associated with flow-through limited partnerships.

This lesson takes approximately 10 minutes to complete.

LEARNING OBJECTIVES

At the end of this lesson, you will be able to:

1 | Explain the sales fees and offering expenses associated with flow-through limited partnerships.

2 | Explain the management fees associated with flow-through limited partnerships.

3 | Explain the other expenses associated with flow-through limited partnerships.

OVERVIEW OF FEES AND EXPENSES

The fees and expenses may vary from one flow-through LP to another. You must read the prospectus or offering memorandum to ascertain the fees and expenses which will apply to any given flow-through LP. Broadly speaking, the fees and expenses associated with a flow-through LP include:

- selling fees and expenses
- management fees
- ongoing expenses

SELLING FEES AND EXPENSES

Selling fees and expenses are comprised of the following:

- **Sales Commissions:** EMDs are usually entitled to a sales commission expressed as a percentage of the subscription price (e.g. 7%)
- **Expenses of the Offering:** The expenses of the offering include:
  - the costs of organizing the LP
  - the costs of printing and preparing the prospectus or offering memorandum
  - legal expenses of the LP and the general partner
  - marketing expenses
  - other costs incurred by the general partner and the selling group of dealers

To maximize the amount invested in the flow-through shares of resource companies, it is common for the LP to finance the sales commission and offering expenses with borrowed money. The principal and interest on the loan are later paid out of the assets of the LP. Thus, the unit holders of the LP ultimately bear the cost of the selling fees and expenses.

MANAGEMENT FEES

The investment manager of the LP is usually entitled to a management fee which is expressed as an annual percentage of the net asset value of the LP (e.g. 2%). The management fee is paid out of the assets of the LP. To maximize the amount invested in flow-through shares of resource companies, the payment of the management fee for the first year is sometimes deferred until after the end of the year.

In some cases, the manager is entitled to a management fee which includes:

- a percentage of the gross subscription proceeds, paid up front (e.g. 2%)
- beginning in Year 2 of the LP, an annual percentage of the net asset value (e.g. 1%)

The investment manager may also be entitled to a performance bonus at the end of the LP's term. The performance bonus may be expressed as a percentage (e.g. 20%) of the amount by which the cumulative performance of the limited partnership throughout its term exceeds a specified threshold return (e.g. 8% per annum).

In some cases, the manager is entitled to flow-through warrants that have been negotiated with the PBCs.

In some cases, the manager may pay a trailer fee to the EMD(s) from the management fees (e.g. 0.25% per annum).

CALCULATING THE NET ASSET VALUE

The net asset value (NAV) of a flow-through LP is calculated in the same manner as a mutual fund. The investment manager determines the value for their net assets in the portfolio and then determines the NAV per unit. The NAV is used as the basis for the calculation of the management fee. The NAV is also used in calculating the conversion ratio when the LP units are rolled over into the mutual fund at the end of the term.

OTHER EXPENSES

A flow-through LP also incurs other expenses in connection with its operation and administration. These may include:

- fees payable to the custodian, the auditor, and the registrar and transfer agent
- fees payable to legal and other advisors
- fees for record-keeping and the preparation of reports to the unit holders
- fees and expenses of the Independent Review Committee
- mailing and printing expenses for periodic reports to the unit holders
- regulatory filing fees
- taxes
- expenses related to portfolio transactions
- cost of expenditures incurred in connection with the mutual fund rollover transaction and the dissolution of the LP

The investment manager sometimes makes advances to the LP in respect of the expenses for the first year to maximize the amount invested in flow-through shares of resource companies.

Risk Factors of Flow-Through Limited Partnerships

5

CONTENT AREAS

INTRODUCTION

In this lesson, you will earn about the risks of flow-through limited partnerships.

This lesson takes approximately 20 minutes to complete.

LEARNING OBJECTIVES

At the end of this lesson, you will be able to:

1 | Understand the risks of investing in the resource sector.

2 | Explain volatility risk associated with cyclical returns.

3 | Explain why flow-through limited partnerships are subject to liquidity risk and concentration risk.

4 | Explain blind pool risk.

5 | Discuss the risks associated with premium, unsubscribed amounts, and the mutual fund rollover.

RISK FACTORS OF FLOW-THROUGH SHARES

The first consideration when contemplating a flow-through investment for a potential investor is their willingness and ability to tolerate the risk associated with adding junior resource companies to their portfolio. The second consideration is the tax benefit, which must be weighed only after you are certain that the client can bear the risks, including the risk of severe capital loss.

RISKS OF INVESTING IN THE RESOURCE SECTOR

The business of a resource company is inherently risky because the discovery of commercially viable quantities of oil, gas, or minerals is unpredictable.

The actual production levels of resource companies may be below expectations for a variety of reasons, including equipment breakdowns and unplanned shutdowns arising from hazards such as unusual or unexpected formations, rock bursts, cave-ins, fires, explosions, blowouts, formations of abnormal pressure, power outages, landslides, and flooding.

Other factors which affect the profitability of a resource company include:

- commodity prices
- the demand for commodities
- general economic conditions
- unanticipated depletion of reserves
- native land claims
- liability for environmental damage
- measures to protect agricultural lands
- inability to hire the required labour or obtain the required equipment
- competition from other resource companies
- the imposition of tariffs, duties, or other taxes

- government regulations affecting the conditions under which oil, gas, and minerals may be developed, produced, and exported
- increases in royalties

For these reasons, the analysis of resource companies is difficult. To compound the difficulty, many resource companies lack a history of earnings and dividends.

Factors to consider when evaluating an investment in a flow-through LP include:

- whether the LP will invest only in mining stocks or in the oil and gas sector as well
- whether the LP will invest primarily in the shares of junior issuers or will there be a mix of junior and more senior issuers

When considering junior issuers, it is important to note that while junior issuers may have the potential for attractive returns, junior issuers are speculative investments.

VOLATILITY RISK AND CYCLICAL RETURNS

Before investment is made in a flow-through share, the investor should be aware of the potential for considerable volatility. The resource sector is cyclical, and in cyclical sectors a period of good performance is inevitably followed by a period of poor performance.

Volatility can arise for a number of reasons including:

- flow-through issuers are typically junior or intermediate companies with more volatile share prices than larger companies
- the resource sector is subject to rapid changes in commodity prices which cannot be predicted or easily managed
- the cyclical nature of the resource sector results in cyclical returns

LIQUIDITY RISK

Liquidity risk arises when an investment product cannot be sold at a fair price, without penalty, and be converted to cash on short notice. Investors in flow-through LPs expose themselves to liquidity risk in two ways. First, the investor must hold the LP until the partnership is dissolved. This could be as long as 24 months after the time of purchase. Second, the underlying companies held in the flow-through LP's portfolio may not be liquid investments, thus further impacting the liquidity of the LP.

CONCENTRATION RISK

Flow-through LPs are inherently subject to concentration risk because they are invested in the resource sector in order to benefit from their favourable tax shelter treatment. As such, the portfolios of the LPs invest in companies with high correlations tied to the same market sector. The higher the correlation, the higher the risk.

Flow-through LPs commonly follow investment criteria designed to mitigate concentration and liquidity risks, such as:

- At least 80% of the portfolio will be invested in resource companies that are listed on a stock exchange
- At least 25% of the portfolio will be invested in resource companies that are listed on a senior exchange such as the TSX, the New York Stock Exchange, the American Stock Exchange, NASDAQ, the London Stock Exchange (including the Alternative Investment Market), the Australian Stock Exchange and the South African JSE Securities Exchange

- Not more than 20% of the portfolio will be invested in a single resource company
- The LP will not own more than 10% of any class of voting securities of a resource company or purchase securities of a resource company for the purpose of exercising control or management over the company

Despite the foregoing criteria, a typical flow-through LP is a concentrated portfolio of junior resource companies without significant assets or financial strength. As such, they are subject to unpredictable swings in value.

BLIND POOL RISK

At the time that investors subscribe for units of a flow-through LP, no investment in PBCs will have been made. The investors are effectively investing in a blind pool. This means that capital is raised from investors before the issuer formally discloses or reports how the capital will be invested. Blind pools offer few restrictions or safeguards for investor security. The investors are totally dependent on the general partner and investment manager to discharge their duties honestly, in good faith, and in the best interests of the limited partners and to invest the LP's money wisely. Therefore, the track record, integrity, and capabilities of the general partner and investment manager are essential factors for consideration when selecting a flow-through LP.

PREMIUM RISK

Due to competition, PBCs are often able to issue flow-through shares at a premium to the market price of similar common shares that do not offer tax benefits. A large premium substantially reduces the investor's prospects for a return on investment. Most analysts agree that there is little prospect for a return when the premium reaches approximately 30%.

Generally, managers with buying power who are continuously present in the market may be able to obtain better prices than managers with less buying power or with a sporadic presence. The buying power of the LP's manager is therefore an important factor for consideration when selecting a flow-through LP.

RISK OF UNSUBSCRIBED AMOUNTS

It is important for the LP to enter into share purchase agreements with resource companies for the total amount subscribed by the end of the year. If it is unable to do so, any amounts not committed will be returned pro rata to the unit holders. In this event, the tax deductions available to the unit holders will be reduced which could result in negative tax consequences to the unit holders.

The unit holders may be required to repay any portion of the subscription price that has been returned to them if it is necessary to pay creditors who extended credit to the LP or whose claims otherwise arose before the amount was returned.

RISKS RELATED TO THE MUTUAL FUND ROLLOVER

At the end of the term of a flow-through LP (usually 18 to 24 months), the "liquidity event" prescribed in the offering documents is scheduled to occur. The liquidity event constitutes a point when the flow-through shares "rollover" and convert into an open-end mutual fund. The mutual fund units are then distributed pro rata to the limited partners and the LP is dissolved.

If the mutual fund rollover does not take place, perhaps because the LP failed to receive a required approval, the limited partners will receive their pro rata share of its assets when the LP winds up. In this event, it may be problematic for the limited partners to exit their investment because there may not be a liquid market for the shares of the resource companies, or the shares may be subject to resale restrictions.

Alternatively, the limited partners may decide not to wind up the LP but to continue it in operation. This would require approval by means of an extraordinary resolution, one passed by at least two-thirds of the votes cast at a duly convened meeting of the limited partners. It is not clear what liquidity the limited partners will obtain for their units in this event.

UNIT SUMMARY

Congratulations, you have reached the end of Unit 8: Flow-Through Shares

In this unit you covered:

- Lesson 1: Characteristics of Flow-Through Shares
- Lesson 2: Tax Considerations of Flow-Through Shares
- Lesson 3: The Benefits of Flow-Through Shares
- Lesson 4: Fees and Expenses of Flow-Through Limited Partnerships
- Lesson 5: Risk Factors of Flow-Through Limited Partnerships

Now that you have completed these lessons, you are ready to assess your knowledge with a 10-question quiz. To start the quiz, return to the IFSE Landing Page and click on the Unit 8 Quiz button.

UNIT 9

THE MINING INDUSTRY

INTRODUCTION

In this unit you will learn about the mining industry.

This unit takes approximately 35 minutes to complete.

Lessons in this unit:

1. Overview of the Mining Industry
2. Securities Regulations for Mining Investments
3. Other Supporting Documents for Mining Investments

Overview of the Mining Industry

1

CONTENT AREAS

- The Mining Industry in Canada
- The Phases of Mining
- Mining Rights
- Exploration and Development
- Production
- Raising Capital for Investment in Mining

INTRODUCTION

In this lesson, you will be provided with an overview of the mining industry.

This lesson takes approximately 15 minutes to complete.

LEARNING OBJECTIVES

At the end of this lesson, you will be able to:

1 | Discuss the size and importance of the mining industry in Canada.

2 | Explain the phases of mining.

3 | Explain mining rights.

4 | Discuss the exploration and development phase of mining.

5 | Discuss the stages of mine production.

6 | Describe raising capital for investment in mining.

7 | Discuss the risks of mining investments.

THE MINING INDUSTRY IN CANADA

Minerals and metals are the raw materials used to build the essentials we rely on from buildings and infrastructure, to automobiles, to the small components in mobile devices. Mining in Canada is a critically important industry and is one of Canada's most important economic sectors. Some basic facts about the Canadian mining industry are summarized in the table below.

Facts about Mining in Canada	
Employment	• Approximately 400,000 people in Canada work in the mining industry • Mining is the largest private sector employer of Aboriginal peoples in Canada • Over 3,200 companies in Canada supply engineering, geotechnical, environmental, financial, and other services to mining operations • Those who work in mining enjoy the highest wages and salaries of all industrial sectors in Canada
Economic Impact	• Mining contributed $52.6 billion to Canada's Gross Domestic Product (GDP) in 2012 • $71 billion in taxes and royalties were paid to Canadian federal and provincial governments from the mining industry from 2003 to 2012 • 20.4% of the goods exported from Canada in 2012 were from the mining industry • Canada's value of mineral production was nearly $47 billion in 2012

Facts about Mining in Canada	
Global Leader	• Canada is one of the largest mining nations in the world producing more than 60 minerals and metals • Canada ranks in the top five countries in the global production of potash, uranium, aluminum, cobalt, titanium, tungsten, cadmium, diamonds, platinum, sulphur, and nickel • Almost 60% of the world's public mining companies are listed on the TSX and TSX-Venture exchanges • 70% of the equity capital raised globally for mining companies is raised on the TSX and TSX-Venture exchanges • Nearly 37% of budgeted worldwide exploration expenditures in 2012 were by Canadian mining companies • Canada has been the recipient of the largest share of global exploration spending since 2004 • Globally, Canada is recognized for its leadership in safety and sustainability. Mining companies in Canada were the first in the world to develop an externally-verified performance system for sustainable mining practices with the creation of MAC's *TOWARDS SUSTAINABLE MINING* (TSM) initiative in 2004

SOURCES: FACTS & FIGURES 2013 (MINING ASSOCIATION OF CANADA), AND NATURAL RESOURCES CANADA, http://mining.ca/resources/mining-facts

THE PHASES OF MINING

Each stage of exploration, development, and operation represents opportunity for investment in the mining industry. The diagram below illustrates the six phases of mining.

The Phases of Mining	
Geoscience	Geoscience surveys provide critical information to encourage exploration investment
Exploration	Exploration carried out by prospectors and companies leads to discoveries of valuable deposits
Discovery	Discovery depends on field work, investment, and quality geoscience to bring exploration to the development stage

The Phases of Mining	
Development	Development includes feasibility, geoscience, and engineering studies, raising capital, and construction
Production	Production includes extraction, milling, and processing to produce coal, metals, industrial minerals, gems and alloys
Reclamation	Reclamation of sites begins during operations and continues after closure until the land is once again productive

Source: Ministry of Energy and Mines, British Columbia, http://www.empr.gov.bc.ca/Mining/Pages/SixEssentialPhasesofMining.aspx

MINING RIGHTS

The mineral rights on more than 90% of Canada's land are government-owned. In Canada, mineral rights cannot be purchased, but may only be leased by companies from the Crown.

The regulation of mineral leases falls under the authority of the provinces and territories of Canada which govern:

- the systems of land tenure and mining rights
- the transfer of mineral rights from one owner to another
- mining and drilling activity

SURFACE AND MINING RIGHTS

When considering a mining proposition, there are two categories of rights:

- **Surface rights:** are those which represent an interest in all of the dirt (rock) from the core of the earth to the surface.
- **Mining rights:** are those which represent an interest in all of the minerals in the dirt (rock) from the core of the earth to and including the surface.

MINERAL CLAIMS AND RIGHTS

In order to embark on mining exploration or extraction, a company must first obtain rights from the government as follows:

- **Mineral Claim:** The holder of a recorded claim acquires the exclusive right to prospect for minerals within the designated area. The recorded claim secures the holder priority for obtaining mineral rights over other parties. Work commitments must be met annually to keep claims in good standing including geological mapping, drilling, and other work.
- **Mineral Rights:** The acquisition of a lease secures title to the minerals for production. The leaseholder owns the exclusive rights to the minerals within the designated area. Yearly lease payments must be made and royalties on the production of the minerals must be paid to the Crown.

Mineral rights do not grant permission for the mining activities of exploration, development, or production. Those activities are subject to land use (surface access requiring permits), environmental, and other regulations.

EXPLORATION AND DEVELOPMENT

Mineral exploration and development are investigative activities prior to mining. In the exploration phase, physical surveys and examinations are conducted to identify potential mineral discoveries. This work may include:

- surface mapping
- remote sensing
- exploratory drilling
- geophysical testing
- geochemical testing

If a mineral deposit is discovered, advanced-stage exploration is carried out to evaluate the geologic discovery to determine whether it should be developed into a mine. This work may include:

- further drilling and sampling
- deposit development
- full technical assessment
- full economic assessment

If the results of the advanced-stage exploration and feasibility studies are positive, it can lead to a decision to proceed to mine development, in which a mine and all associated facilities and infrastructure are planned, designed, and constructed.

The price volatility of investments is greater in these early stages of mineral exploration and development.

PRODUCTION

The production phase of mining includes extraction, milling, and processing to produce coal, metals, industrial minerals, gems, and alloys. The diagram below illustrates the four phases of mining production.

The Production Stages of Mining	
Extraction	Open-pit or underground mining is carried out to excavate and extract ore containing metals or gems
Milling	Raw metallic ore is ground and crushed into fine material and then separated into concentrate (mineralized product) and waste rock (tailings)

The Production Stages of Mining	
Smelting	Extractive metallurgy is carried out to heat and/or chemically treat mineralized concentrate and separate it further from molten slag to produce base metals for refinement
Refining	Purification processes such as electrolysis are carried out to treat the metallic product from the smelter to remove impurities and produce high purity metals

The production phase of mining also includes the processes used to produce alloys. An alloy is a material composed of two or more metals or a fusion of metals and a nonmetals. Thousands of alloys are produced from this fusion process including steel, stainless steel and silicon steel.

RAISING CAPITAL FOR INVESTMENT IN MINING

Canada is the leading global centre for mining finance. The Toronto Stock Exchange (TSX) is home to 57% of the world's public mining companies and traded more than $280 billion of mining stock in 2012. Of the firms listed on the TSX, 364 are mining companies. These firms, together valued at $381.1 billion, raised $7.5 billion in equity capital in 2012.[1]

A diverse range of investment opportunities are available in the Canadian mining industry including equities, debt financing, flow-through shares and flow-through limited partnerships in both the public and private markets.

INVESTING IN MINING COMPANIES

When considering a mining investment, it is important to consider whether the investment relates to:

- a junior company; or
- a senior company.

The characteristics of junior companies and senior companies are detailed in the table below.

Junior versus Senior Companies	
Junior Companies	• usually have no regular source of income and must finance their projects by selling shares • raise money for exploration and make their profits by selling or optioning their developing claims to a larger company • do not make money from actively producing mines • financing is most commonly raised by issuing treasury shares • debt financing is difficult (it is unusual to loan money for exploration) • information primarily relies on future projections with minimal data to substantiate the projections

[1] Source: *Facts and Figures of the Canadian Mining Industry 2013*, The Mining Association of Canada

Junior versus Senior Companies	
Senior Companies	• normally derive income from mining or other business ventures • generally make money from actively producing mines • financing can usually be raised through normal channels and debt financing • information on corporate returns, financials, and projections is usually supported by hard data

RISKS OF MINING INVESTMENTS

Investment in the mining industry, by nature, is inherently risky because the discovery of commercially viable quantities of minerals is unpredictable. Other factors which affect the profitability of a mining company include:

- commodity prices
- the demand for commodities
- unanticipated depletion of reserves
- environmental hazards
- safety hazards
- political risks
- native land claims
- labour constraints
- equipment failures

Where the investment involves producing mines, production levels could disappoint and fall below projections for a variety of reasons, such as those above.

JUNIOR MINING COMPANY VERSUS SENIOR MINING COMPANY

When considering a mining investment, it is important to consider whether the investment relates to a junior company or a senior company. Junior companies are speculative investments focused on the exploration of mineral deposits. Factors to consider in relation to junior companies include that:

- the company will typically not have a regular source of income
- there will typically not be any records for earnings or dividends
- there is no assurance that exploration will result in a discovery
- the offering price for the securities does not typically reflect the assets of the company, rather it is negotiated between the issuer and the underwriter

It is not uncommon for a junior company to fail because capital has been depleted and exploration has not yielded a mineral discovery. Junior companies are speculative investments and only those investors who are willing to risk 100% of their investment should consider these types of investments.

VOLATILITY RISK AND CYCLICAL RETURNS

Investors should be aware of the potential for considerable volatility in a mining investment. Volatility can arise from rapid changes in commodity prices and the cyclical nature of the mining sector. The securities of junior mining companies, in particular, are subject to drastic changes in price and volatility.

Securities Regulation for Mining Investments

2

CONTENT AREAS

INTRODUCTION

In this lesson, you will learn about the securities regulations for mining investments.

This lesson takes approximately 10 minutes to complete.

LEARNING OBJECTIVES

At the end of this lesson, you will be able to:

1 | Discuss the requirements of National Instrument 43-101 (NI 43-101).

2 | Define a qualified person (QP).

3 | Explain the standard terminology under NI 43-101.

4 | Discuss the written disclosure requirements under NI 43-101.

5 | Explain the technical report (Form 43-101F1) requirements under NI 43-101.

OVERVIEW OF SECURITIES REGULATIONS

Investments in the mining industry are subject to the legislation and regulations of the provincial securities commissions and regulators. Those securities offered by prospectus are subject to the requirements of the reporting issuer regime for public companies. Securities offered under an exemption from prospectus requirements are subject to the requirements governing the exempt market and may only be purchased by certain investors who qualify for exemption (e.g. accredited investor exemption, eligible investor under the offering memorandum exemption, etc.).

You should thoroughly review the offering documents as a matter of your due diligence obligations.

NATIONAL INSTRUMENT 43-101

National Instrument 43-101 *Standards of Disclosure for Mineral Projects* (NI 43-101) establishes the disclosure requirements for scientific and technical information regarding mineral projects. These disclosure requirements are in addition to the continuous disclosure requirements under the reporting issuer regime. NI 43-101 requires that the disclosure of scientific and technical information relating to mineral projects be based on a technical report or other information prepared by or under the supervision of a qualified person (QP).

The instrument encompasses, among other things, the following matters:

- Standard terminology
- Disclosure requirements
- Additional requirements of written disclosure:
  - qualified person (QP)
  - data verification
  - exploration disclosure
  - mineral resources and reserves disclosure
- Technical Report

QUALIFIED PERSON

NI 43-101 specifies that all disclosure of scientific or technical information concerning a mineral project must be based upon information prepared by or under the supervision of a qualified person. A qualified person is defined as:

- an individual, not a firm or company
- an engineer or geoscientist with a minimum of 5 years industry experience and a university degree (or equivalent)
- an individual with relevant experience who is a member in good standing of a recognized "professional association" of engineers, geoscientists or both that is either recognized by statute in Canada, or a generally accepted foreign association

STANDARD TERMINOLOGY

NI 43-103 requires that the terminology used in disclosure of scientific or technical information concerning a mineral project must ascribe to the terms and categories adopted by the Canadian Institute of Mining, Metallurgy and Petroleum ("CIM").

The mandatory CIM terms and categories are summarized in the table below.

Mandatory CIM Terms and Categories	
Mineral Resource	• a concentration or occurrence of minerals in such form and quantity and of such grade or quality that it has reasonable prospects for economic extraction • Mandatory categories: ◦ Inferred mineral resource ◦ Indicated mineral resource ◦ Measured mineral resource
Mineral Reserve	• the economically mineable part of a measured or indicated mineral resource demonstrated by, at minimum, a *Preliminary Feasibility Study* • a mineral resource which, in the opinion of the qualified person (QP), is the basis of an economically viable project • Mandatory categories: ◦ Probable mineral reserve ◦ Proven mineral reserve

As established in section 2.3 of NI 43-101, issuers are restricted from disclosing scientific or technical information concerning a mineral project which does not ascribe to the mandatory terms and categories of the CIM.

WRITTEN DISCLOSURE

NI 43-101 establishes requirements with respect to written disclosure of scientific or technical information which requires that the disclosure must:

- include the name of the qualified person (QP)
- state whether the data was verified by the QP and:
  - if so, how
  - if not, why not

- satisfy the requirements applicable to exploration information
- satisfy the requirements applicable to mineral resources and mineral reserves

TECHNICAL REPORT

NI 43-101 establishes obligations to file a technical report in prescribed form (Form 43-101F1) when:

- the issuer becomes a reporting issuer
- the issuer discloses scientific or technical information regarding mineral properties that is contained in public documents (e.g. prospectus, proxy circular, rights offering circular, etc.)
- the issuer discloses scientific or technical information regarding mineral properties that is contained in an offering memorandum (unless provided only to accredited investors)
- any written disclosure made by or on behalf of an issuer that discloses, for a first time, a material change in the mineral resources, mineral reserves, or the result of a preliminary economic assessment on the property

NI 43-101 prescribes that a technical report must be prepared by or under the supervision of one or more qualified persons (QP) and that the report be independent. The instrument specifies the parameters for preparation of the report, the certifications and consents of qualified persons, and the prescribed form for filing the report (Form 43-101F1).

Other Supporting Documents for Mining Investments

3

CONTENT AREAS

INTRODUCTION

In this lesson, you will learn about other supporting documents for mining investments.

This lesson takes approximately 10 minutes to complete.

LEARNING OBJECTIVES

At the end of this lesson, you will be able to:

1 | Discuss the importance of reviewing the documents pertaining to a mining investment.

2 | Describe feasibility reports.

3 | Describe mineral assessment reports.

4 | Explain joint venture agreements, royalty agreements, and offtake agreements.

OTHER SUPPORTING DOCUMENTS FOR MINING INVESTMENTS

Analysis of a mining investment is complex and requires thorough review of the pertinent documents. Alongside the offering documents, the prospectus (public) or offering memorandum (private), the required reporting issuer disclosures, and the technical reports (Form 43-101F1) prescribed under securities regulation, all other supporting documents warrant thorough examination and review. Other supporting documents include those which detail the company's corporate history, experience and capabilities of management, and projections for viability.

ECONOMIC AND FEASIBILITY REPORTS

If a mineral deposit is discovered, advanced-stage exploration is carried out which encompasses feasibility studies including:

- Preliminary Economic Assessment (lowest confidence level)
- Preliminary Feasibility Study (reasonable confidence level)
- Feasibility Study (highest confidence level)

PRELIMINARY ECONOMIC ASSESSMENT

A preliminary economic assessment is a study that includes an economic analysis of the potential viability of mineral resources (sometimes also referred to as a "scoping study").

PRELIMINARY FEASIBILITY STUDY

A preliminary feasibility study is a comprehensive study of a *range of options* for the technical and economic viability of a mineral project that has advanced to a stage where a preferred mining method is established, and an effective method of mineral processing is determined. It includes a financial analysis based on reasonable assumptions on mining, processing, metallurgical, economic, marketing, legal, environmental, and social and governmental considerations sufficient for the qualified person (QP) to determine if all or part of a mineral resource may be classified as a mineral reserve.

FEASIBILITY STUDY

A feasibility study is a comprehensive technical and economic study of the *selected development option* for a mineral project that includes appropriately detailed assessments of realistically assumed mining, processing, metallurgical, economic, marketing, legal, environmental, social and governmental considerations, together with any other relevant operational factors and detailed financial analysis, that are necessary to demonstrate that extraction is reasonably justified (i.e. economically mineable). The results of the study may serve as the basis for a final decision to proceed with, or finance, the development of the project.

MINERAL ASSESSMENT REPORT

Most provinces and territories require a recorded holder of a mining claim to complete and file certain mineral assessment work reports to maintain a mining claim in good standing. The experience and technical knowledge of the team performing this work will guide the value of the mineral prospect. The report must show the location, nature, and extent of the work, the persons who performed the work, the date of performance, and other prescribed information.

AGREEMENTS

The legal construct under which a mining company develops its project can have a direct bearing on its return on investment. As such, legal agreements between the mining company and other parties are of critical importance and therefore warrant thorough review. Some of these agreements include:

- Joint Venture Agreements
- Royalty Agreements
- Offtake Agreements

JOINT VENTURE AGREEMENTS

The capital costs of mining projects begin to climb exponentially as the search for minerals leads to exploration and development in more remote and elevated areas of the world. Many major producing mining companies are now entering into joint ventures as a means of sharing financial commitments and risk in order to develop mining projects. The terms of the governing joint venture agreement will establish the financial and other related rights, liabilities, and obligations of the joint venture parties.

ROYALTY AGREEMENTS

Royalties often encumber mining rights interests. As prospectors transfer their mining rights to companies capable of development and operation, royalties are often retained as a means of participating in the potential mineral production. Some projects may have multiple royalties layered on mineral production from a mine. The number and terms of such royalty agreements can significantly affect the financial viability of a mining investment. Royalties are often in the form of vendor take-back, but they may also arise as a form of direct financing or as a means of ongoing income participation after the dilution of interest. The terms of any royalty agreement(s) must be examined to determine the impact of the royalties on the projected cash flow of a project and the value of the mining investment.

OFFTAKE AGREEMENTS

Offtake agreements are agreements between a producer and a buyer of a resource. The buyer agrees to buy all or a portion of the producer's future production from a specified facility. Offtake agreements are frequently used in natural resource development where the capital costs to extract the resource is significant and the company wants to ensure that some of its product will be sold. If potential lenders or investors are confident that the company will have a buyer for all or a significant portion of its production, it makes it easier to obtain financing to construct a mine. Recent years have seen major international mining companies enter into equity investments of start-up mine projects and simultaneously enter into offtake agreements to ensure product supply.

There are several factors that should be considered when dealing with offtake agreements in relation to quality, quantity, and price. It is important to determine whether the contract is a firm buy/sell agreement, an option contract, or a combination of both. The more solid the buy/sell clause is, the more it ensures that a future economic relationship is guaranteed to take place.

UNIT SUMMARY

Congratulations, you have reached the end of Unit 9: The Mining Industry

In this unit you covered:

- Lesson 1: Overview of the Mining Industry
- Lesson 2: Securities Regulations for Mining Investments
- Lesson 3: Other Supporting Documents for Mining Investments

Now that you have completed these lessons, you are ready to assess your knowledge with a 10-question quiz. To start the quiz, return to the IFSE Landing Page and click on the Unit 9 Quiz button.

UNIT 10

THE OIL AND GAS INDUSTRY

INTRODUCTION

In this unit you will learn about the oil and gas industry.

This unit takes approximately 35 minutes to complete.

Lessons in this unit:

1. Overview of the Oil and Gas Industry
2. Investment in the Oil and Gas Industry
3. Securities Regulation for Oil and Gas Investments

Overview of the Oil and Gas Industry

1

CONTENT AREAS

The Oil and Gas Industry in Canada
The Stages of Oil and Gas
Mineral Rights
Exploration, Appraisal, and Development
Production
Refining Oil
Gas Processing
Distribution and Transportation
Petrochemicals

INTRODUCTION

In this lesson, you will be provided with an overview of the oil and gas industry.

This lesson takes approximately 15 minutes to complete.

LEARNING OBJECTIVES

At the end of this lesson, you will be able to:

1 | Discuss the size and importance of the oil and gas industry in Canada.

2 | Explain the stages of oil and gas.

3 | Explain the mineral rights for oil and gas.

4 | Discuss the exploration, appraisal, and development stage of oil and gas.

5 | Discuss the production stage of oil and gas.

6 | Explain oil refining and gas processing.

7 | Discuss petrochemicals.

THE OIL AND GAS INDUSTRY IN CANADA

Oil and gas are the raw materials which provide the energy we rely on to generate light, heat, and the necessities of our lives. The importance of the energy provided by fossil fuels cannot be overestimated and the International Energy Agency states that fossil fuels will remain our primary source of energy for the foreseeable future. The demand for energy has continually expanded in tandem with the growth in global population and the advancement of societies in emerging markets.

The importance of the oil and gas industry to the Canadian economy cannot be overstated. Some basic facts about the Canadian oil and gas industry are summarized in the table below.

Facts about Oil and Gas in Canada	
Employment	• The oil and gas industry employs 550,000 in Canada (direct & indirect)
Economic Impact	• Crude oil accounts for 17% of Canada's merchandise exports • Payments to governments from oil & gas are $18 billion per year • $74 billion was invested in oil & gas in 2013: ◦ 20% of value on Toronto Stock Exchange ◦ largest single private investor in Canada

Facts about Oil and Gas in Canada	
Global Leader	Canada is ranked the: • 3rd in the world in crude oil reserves (after Saudi Arabia and Venezuela) • 5th largest crude oil producer • 5th largest natural gas producer • 5th largest energy producer Exports: • Crude oil: 2.555 million barrels per day • Natural Gas: 7.95 billion cubic feet per day

SOURCE: CANADIAN ASSOCIATION OF PETROLEUM PRODUCERS (CAPP), HTTP://WWW.CAPP.CA/LIBRARY/STATISTICS/BASIC/PAGES/DEFAULT.ASPX

THE STAGES OF OIL AND GAS

Each stage of exploration, development, and production represents opportunity for investment in the oil and gas industry. The oil and gas industry is classified into two main categories:

- **Upstream:** operations include exploration, appraisal, development, and production
- **Downstream:** operations include refining, petrochemicals, distribution, and marketing

The diagram below illustrates the five stages of oil and gas operations.

The Stages of Oil and Gas		
Upstream	Exploration	Searching for underground or underwater reserves: geophysics, gravity surveys, magnetic surveys, seismic surveys, exploration wells
	Appraisal	Appraisal of wells, evaluation of seismic and drilling results, environmental assessments, conceptual field development and planning
	Development	Raising capital, construction of wells, process facilities, infrastructure, terminal/export facilities
	Production	Primary and secondary (enhanced) recovery of reserves, preparing oil and gas for use in the refinery or processing plant

The Stages of Oil and Gas		
Downstream	Refining, Processing, and Petrochemicals	Refining, distillation, and processing to turn crude oil and gas into marketable products, processing of petrochemicals, transportation and distribution of products to market

MINERAL RIGHTS

The mineral rights for oil and gas, as with those for all other minerals, are largely government-owned and must be leased from the Crown by the companies who want to explore and recover those resources. In order to embark on exploration and development for oil and gas, a company must first obtain rights from the government as follows:

- **Mineral Claim:** The holder of a recorded claim acquires the exclusive right to prospect for minerals within the designated area. The recorded claim secures the holder priority for obtaining mineral rights over other parties. Work commitments must be met annually to keep claims in good standing including geological mapping, drilling, and other work.
- **Mineral Rights:** The acquisition of a lease secures title to the minerals for production. The leaseholder owns the exclusive rights to the minerals within the designated area. Yearly lease payments must be made and royalties on the production of the minerals must be paid to the Crown.

Mineral rights do not grant permission for the activities of exploration, development, or production. Those activities are subject to land use (surface access requiring permits), environmental, and other regulations.

EXPLORATION, APPRAISAL, AND DEVELOPMENT

The exploration for oil and gas involves the search for hydrocarbons in sedimentary rock formations. Exploratory activities and physical surveys are conducted to identify potential reserves. This work may include:

- geophysics
- magnetic surveys
- gravity surveys
- seismic surveys
- exploration wells

Where a reserve is discovered, appraisal follows with the purpose of obtaining data about the reserve in order to make a decision on whether or not to proceed with the development of the field. This work may include:

- further seismic surveys
- evaluation of the results from the seismic and drilling activities
- computer reservoir simulation models
- environmental assessments
- conceptual field development planning

Where it is determined that a reserve has the potential to be commercially viable, capital is raised to fund the development of the field and planning, design, and construction of the wells, process facilities, infrastructure, and terminal/export facilities proceeds.

PRODUCTION

The production stage of oil and gas involves the recovery of hydrocarbons including crude oil, gas, and bitumen from the earth. The table below details the production stage of oil and gas.

Oil and Gas Production	
Conventional Oil	Conventional light or heavy oil is recovered by oil wells using a number of different methods involving pressure, heat, and water injection (or natural gas, chemicals, and other solvents), or fracking. To maximize recovery, multiple methods may involve both: • Primary recovery • Secondary (enhanced) recovery
Oil Sands	Oil sands are a mixture of sand, water, clay, and bitumen. Bitumen is oil that is too heavy or thick to flow or be pumped without being diluted or heated. Oil sands are recovered using two main methods: • Open-pit mining (20%) • In situ drilling with thermal techniques (80%)
Gas	Natural gas is recovered by drilling wells into the ground to remove the gas. Similar to oil recovery, the methods for recovery vary depending on the rock formations of the reserve and can commonly include methods such as fracking.

REFINING OIL

Oil refining turns crude oil into marketable products. The refining process starts with fractional distillation which separates the crude oil into separate components. The products are then further processed and improved with chemical additives to produce marketable products including gasoline, diesel, heating oil, and jet fuel as well as residual products including asphalt and industrial fuel.

GAS PROCESSING

Gas processing turns natural gas into marketable products. The gas process starts with dehydration to remove water from the gas and then it is treated in order to separate the product into pipe-line quality products which include ethane, propane, and methane (known as natural gas).

DISTRIBUTION AND TRANSPORTATION

The oil and gas sector includes the distribution and transportation component of the industry. Oil and gas are transported from the refineries to terminals, and then from the terminals to wholesale and retail outlets. Oil and gas are transported by pipelines, tankers, rail and truck.

PETROCHEMICALS

Petrochemicals are produced from oil and natural gas. Oil refineries produce:

- olefins: including ethylene and propylene
- aromatics: including benzene, toluene and xylene isomers

From these compounds, a wide variety of commercial materials are produced including polyesters, nylons, polyvinyl, plastics, engine coolant, refrigerants, anti-freeze, detergents, solvents, alcohols, acrylics, epoxies, adhesives, synthetic rubber, insecticides, and lubricants.

Investment in the Oil and Gas Industry

2

CONTENT AREAS

- Oil and Gas Prices
- Raising Capital for Oil and Gas
- Investing in Oil and Gas Companies
- Risks of Oil and Gas Investments
- Potential Benefits

INTRODUCTION

In this lesson, you will learn about investment in the oil and gas industry.

This lesson takes approximately 15 minutes to complete.

LEARNING OBJECTIVES

At the end of this lesson, you will be able to:

1 | Explain how oil and gas prices are determined.

2 | Discuss benchmarks, barrel of equivalent, and market differential.

3 | Describe the strategies for raising capital for oil and gas ventures.

4 | Explain play type.

5 | Discuss junior versus senior companies.

6 | Explain the risks of oil and gas investments.

7 | Discuss the potential benefits of investment in oil and gas.

OIL AND GAS PRICES

One of the important factors to consider when contemplating an investment in oil and gas, or any other commodity, is the price of the commodity itself. The price that the commodity commands in the marketplace will have a direct bearing on corporate profits, plans for expansion and production projects, and ultimately performance of the investment.

Oil and gas prices are established in the market based on variables including supply and demand, production levels, storage levels, and views on future trends in any of these or other variables.

The price movement of an oil and gas investment will be impacted by the following price factors:

- Benchmark price
- Barrel of oil equivalent
- Market differentials

BENCHMARK PRICE

The benchmarks for oil and gas provide the reference price for buying and selling oil and gas. The major benchmarks for oil are:

- Brent Crude
- Western Texas Intermediate (WTI)

The major gas benchmark is:

- NYMEX Natural Gas

It is important to note that the benchmarks do not set the prices for oil and gas. As with any other commodity, prices are determined by the market forces of supply and demand. The benchmarks provide the reference price for buying and selling.

BARREL OF OIL EQUIVALENT

The barrel of oil equivalent (BOE) is a term used to express the amount of energy equal to the energy in a barrel of oil. The BOE is used to report the amount of energy a company produces or has in reserves, as an alternative to other references such as barrels of oil or cubic feet of natural gas.

MARKET DIFFERENTIALS

Market differentials express the difference between benchmark prices. For example, the differential between Western Texas Intermediate (WTI) and Western Canadian Select (WCS). The differential is the price difference that the oil from each supply chain commands in the marketplace.

RAISING CAPITAL FOR OIL AND GAS

The oil and gas sector is an integral part of the investment landscape in Canada. Oil and gas investments represent 20% of the value of the Toronto Stock Exchange and the largest source of private investment, with $74 billion invested in oil & gas in 2013.

Oil and gas companies may employ a number of capital raising strategies in order to raise funds for exploration and development. Companies at every level, from the super major to the private junior company, will consider participation sharing of some kind in order to raise capital for ventures. Venture sharing arrangements include the following:

- **Production Sharing and Participation Loans:** The lender supplies capital for a specific venture and a portion of the cash flow from production is returned to the lender to service the debt and provide a share of the profit.
- **Joint Venture Agreement:** Two or more companies enter into an arrangement and create a separate entity for a specific joint venture. The parties pool their resources and share financial commitments under the joint venture entity, separate and apart from their other businesses.
- **Farm-In Agreement:** One company (the Farmor) engages a third party (the Farmee) in order to gain capital, expertise, and support for the development of a reserve. The Farmee provides capital up front, technology, and resources for exploration and development in exchange for an interest in the reserve.

INVESTING IN OIL AND GAS COMPANIES

A diverse range of investment opportunities are available in the Canadian oil and gas industry including equities, debt financing, flow-through shares, and flow-through limited partnerships in both the public and private markets.

When considering investment in the oil and gas industry, there are a number of factors to consider including:

- play type
- junior versus senior company

PLAY TYPE

The oil and gas industry will refer to a resource as a 'play' type. The factors that define the play are:

- the type of commodity (oil, natural gas); and
- the geology (the physical features of the reservoir) which impact extraction of the resource.

Oil and gas play types fall into two categories, conventional or unconventional, as shown in the table below.

Play Type	
Conventional	• vertical or horizontal wells drilled to follow carbonate trends or a shallow marine reef • the development of deposits where rock characteristics show suitable porosity and permeability for fluid flow • lower capital cost for recovery
Unconventional	• characterized by challenging reservoir conditions that necessitate specialized extraction techniques • includes, for example, tight sand or shale where the rock exhibits very low propensity for fluid flow, such as oil sands or shale gas • higher capital cost for recovery

JUNIOR VERSUS SENIOR COMPANY

As with any other investments in minerals, when considering an investment in oil and gas, it is important to consider whether the investment relates to:

- a junior company; or
- a senior company.

The characteristics of junior companies and senior companies are detailed in the table below.

Junior versus Senior Companies	
Junior Companies	• usually have no regular source of income and must finance their projects by selling shares • raise money for exploration and make their profits by selling or optioning their developing claims to a larger company • do not make money from actively producing fields • financing is most commonly raised by issuing treasury shares • debt financing is difficult (it is unusual to loan money for exploration) • information primarily relies on future projections with minimal data to substantiate the projections

Junior versus Senior Companies	
Senior Companies	• normally derive income from production and downstream activities, or other business ventures • generally make money from actively producing fields, refineries, pipelines, etc. • financing can usually be raised through normal channels and debt financing • information on corporate returns, financials, and projections is usually supported by hard data

RISKS OF OIL AND GAS INVESTMENTS

Investment in the oil and gas industry, by nature, is inherently risky because it is highly cyclical and the discovery of reserves is unpredictable. Other factors which affect the profitability of a petroleum company include:

- oil and gas prices
- the demand for oil and gas
- unanticipated depletion of reserves
- environmental hazards
- safety hazards
- political risks
- native land claims
- labour constraints
- equipment failures

JUNIOR COMPANY VERSUS SENIOR COMPANY

When considering an investment in oil and gas, it is important to consider whether the investment relates to a junior company or a senior company. Junior companies are speculative investments focused on the exploration of reserves.

Junior companies typically do not have a regular source of income and will not have records for earnings or dividends. As such, the price of the offering will not be based on assets of the company but will be a price that has been negotiated by the issuer and the underwriter.

Junior companies are focused on the exploration for possible reserves, however there is no assurance that exploration will be successful. It is not uncommon for a junior company to fail because capital has been depleted and exploration has not yielded a discovery of reserves. Junior companies are speculative investments and only those investors who are willing to risk 100% of their investment should consider these types of investments.

VOLATILITY RISK AND CYCLICAL RETURNS

Investors should be aware of the potential for considerable volatility in an oil and gas investment. Volatility can arise from rapid changes in commodity prices and the cyclical nature of the oil and gas sector. The securities of junior companies, in particular, are subject to drastic changes in price and volatility.

CONVENTIONAL PLAY VERSUS UNCONVENTIONAL PLAY

It is important to consider whether the investment involves a conventional or unconventional play. For example, a conventional oil and gas opportunity likely exhibits a lower technical risk than a company deploying new and possibly unproven technology. Conventional drilling and production is also less capital intensive than unconventional recovery.

POTENTIAL BENEFITS

Investments in early-stage oil and gas exploration are speculative investments which will make most investors uneasy. While the risks are significant, there is the potential for attractive returns for the appropriate investor who has a high tolerance to risk and the willingness to speculate. An example of early-stage investment that was a resounding success is the oil sands development in Alberta. Canada has the third largest oil reserves in the world and 97% of Canada's oil reserves are in the oil sands. The Alberta oil sands has given rise to success stories including Suncor, Canadian Natural Resources, and Cenovus Energy. Early-stage investment in these giants has produced exponential returns.

Figure 10.1

Securities Regulation for Oil and Gas Investments

3

CONTENT AREAS

INTRODUCTION

In this lesson, you will learn about securities regulation for oil and gas investments.

This lesson takes approximately 10 minutes to complete.

LEARNING OBJECTIVES

At the end of this lesson, you will be able to:

1 | Discuss the requirements in national instrument 51-101 (NI 51-101).

2 | Discuss the standards in the Canadian Oil and Gas Evaluation Handbook (COGEH).

3 | Define resources.

4 | Define reserves.

5 | Explain the methods to estimate quantity of oil and gas reserves.

OVERVIEW OF SECURITIES REGULATIONS

Investments in the oil and gas industry are subject to the legislation and regulations of the provincial securities commissions and regulators. Those securities offered by prospectus are subject to the requirements of the reporting issuer regime for public companies. Securities offered under an exemption from prospectus requirements are subject to the requirements governing the exempt market and may only be purchased by certain investors who qualify for exemption (e.g. accredited investor exemption, eligible investor under the offering memorandum exemption, etc.).

NATIONAL INSTRUMENT 51-101 (NI 51-101)

National instrument 51-101 *Standards of Disclosure for Oil and Gas Activities* (NI 51-101) establishes the disclosure requirements for reporting issuers engaged in oil and gas activities. These disclosure requirements are in addition to the continuous disclosure requirements under the reporting issuer regime.

In 2002, when the Calgary chapter of the Society of Petroleum Evaluation Engineers (SPEE) published the *Canadian Oil and Gas Evaluation Handbook* (COGEH), the standards established in Section 5 pertaining to the evaluation of resources and reserves were adopted in the disclosure requirements of NI 51-101.

NI 51-101 encompasses, among other things, the matters summarized in the table below.

NI 51-101	
Standard Terminology	• in accordance with the Canadian Oil and Gas Evaluation Handbook (COGEH): ∘ oil and gas resources ∘ oil and gas reserves
Annual Filing Requirements	• statement of reserves • report of independent qualified reserves evaluator or auditor • report of management and directors

NI 51-101	
Responsibilities of Reporting Issuers	• appointment of an independent qualified reserves evaluator or auditor • reserves committee
Measurement	• measurement of reserves data in accordance with the COGEH
Disclosure Requirements	• all disclosure • material change disclosure

The COGEH establishes protocols for the following:

- preparation of a reserve or resource estimate
- business practices
- qualifications of reserve evaluators and auditors
- definitions:
    - evaluations, audits, and reviews
    - oil and gas resources
    - oil and gas reserves
- classification system
- guidelines and evaluation examples

RESOURCES AND RESERVES

The COGEH classifies oil and gas resources and oil and gas reserves for evaluation. The COGEH classifications for resources and reserves are summarized in the table below.

Resources and Reserves	

Resource	• **Original resource:** oil and gas which is estimated to exist in naturally occurring accumulations:
	  ◦ low estimate: conservative
	  ◦ best estimate: best
	  ◦ high estimate: optimistic
	• Original resource:
	  ◦ discovered
	  ◦ undiscovered
	• **Discovered resource:** oil and gas estimated from known accumulations
	  ◦ recoverable (ultimate reserve)
	  ◦ unrecoverable

Resources and Reserves	
	• **Undiscovered resource:** oil and gas estimated to be in accumulations yet to be discovered: ∘ recoverable ∘ unrecoverable
Reserve	• **Reserve:** oil or gas which is anticipated to be economically recoverable from discovered resources ∘ *proved reserve:* high degree of certainty to be recoverable ∘ *probable reserve:* less certainty to be recoverable than proved reserve ∘ *possible reserve:* less certainty to be recoverable than probable reserve
Estimate	• Proved: conservative • Proved + Probable: realistic • Proved + Probable + Possible: optimistic

RESERVE CATEGORIES

Ultimately the value of reserves are tied to the value of the commodity (grade or quality) and the complexity of resource extraction. Reserves are classified into three categories:

- proved (P1)
- probable (P2)
- possible (P3)

Each category implies an increasing range of uncertainty and risk of recovery.

METHODS TO ESTIMATE QUANTITY

The quantity of reserves is estimated by volumetric method, material balance, or decline analysis.

- **Volumetric analysis:** establishes rock porosity and fluid saturation of oil, gas, and water allowing for the calculation of an expected volume of production across the well or wells drainage area.
- **Material balance:** considers the same factors as volumetric analysis with the added measure of reservoir pressure regimes in order to calculate potential production volumes.
- **Decline analysis:** establishes the future anticipated rate of production over time and generally requires the benefit of historical production data.

CONCLUSION

Whether an oil and gas investment is offered by a reporting issuer by prospectus or by a private placement in the exempt market, it is important to have an understanding of the disclosures contained in the offering documents which pertain to the evaluation of oil and gas resources and oil and gas reserves.

UNIT SUMMARY

Congratulations, you have reached the end of Unit 10: The Oil and Gas Industry

In this unit you covered:

- Lesson 1: Overview of the Oil and Gas Industry
- Lesson 2: Investment in the Oil and Gas Industry
- Lesson 3: Securities Regulation for Oil and Gas Investments

Now that you have completed these lessons, you are ready to assess your knowledge with a 10-question quiz. To start the quiz, return to the IFSE Landing Page and click on the Unit 10 Quiz button.

UNIT 11

HEDGE FUNDS

INTRODUCTION

In this unit you will learn about hedge funds.

This unit takes approximately 2 hours and 15 minutes to complete.

Lessons in this unit:

1. Characteristics of hedge funds
2. Hedge fund transactions
3. Hedge fund investment strategies
4. Risk and return
5. Operations of a hedge fund
6. Tax considerations of hedge funds
7. Benefits of hedge funds
8. Hedge Fund Fees
9. Risks of hedge funds

Characteristics of Hedge Funds 1

CONTENT AREAS

INTRODUCTION

In this lesson, you will learn about the characteristics of hedge funds.

This lesson takes approximately 10 minutes to complete.

LEARNING OBJECTIVES

At the end of this lesson, you will be able to:

1 | Define hedge funds.

2 | Explain the distinction between absolute return and relative return.

3 | Explain the distinction between the investment mandates for mutual funds and hedge funds.

4 | Explain the distinction between the distribution of public mutual funds and private hedge funds.

5 | Describe the role of AIMA Canada.

WHAT IS A HEDGE FUND?

The term "hedge fund" is not defined in securities legislation. However, it is generally understood to refer to investment funds which share the following characteristics:

- their objective is typically to generate absolute returns
- they have broad investment mandates
- the funds are privately distributed

ABSOLUTE RETURN

Hedge funds typically seek to generate positive returns in all market conditions. This is known as absolute return investing. This differs from traditional mutual funds which have relative return objectives. The characteristics of absolute return investing compared to relative return investing is summarized in the table below.

Return Objectives	
Conventional Mutual Funds	**Hedge Funds**
Relative Return • Compared to the market, indices, benchmarks, and peers • E.g. S&P/TSX Composite index	**Absolute Return** • Return over time, irrespective of the market
Long-Only Strategy • Must predominantly buy long • Strict limits on short selling	**Long and Short Strategies** • Can freely employ either buying long or selling short as a strategy

Return Objectives	
Conventional Mutual Funds	**Hedge Funds**
Traditional Asset Classes • Money market, bonds, stocks • Strict limits on derivatives	**Traditional and Alternative Asset Classes** • Traditional: money market, bonds, stocks • Alternative: derivatives, private equity, commodities, real estate, etc.

INVESTMENT MANDATE

Conventional mutual funds are subject to the requirements of National Instrument 81-102 (NI 81-102) which places restrictions on their investment mandates in order to support the liquidity requirements dictated by their redemption feature needs. In contrast, hedge funds are not subject to the requirements of NI 81-102 and can therefore employ broad investment mandates without restrictions. A comparison of the investment mandates for mutual funds and hedge funds is summarized in the table below.

Investment Mandate	
Conventional Mutual Funds	**Hedge Funds**
Strict limits on: • derivatives and alternative investments • short selling • concentration Prohibited from using: • leverage	No restrictions or limits on: • derivatives and alternative investments • short selling • concentration • leverage

PRIVATE DISTRIBUTION

Traditional public mutual funds are distributed by prospectus and are subject to the continuous disclosure regime of reporting issuers. In contrast, hedge funds are offered under an exemption from prospectus requirements. As with all securities offered in the exempt market, hedge funds are distributed primarily by way of an offering memorandum (OM) and may only be purchased by certain investors who qualify for exemption (e.g. accredited investor exemption, eligible investor under the offering memorandum exemption, etc.).

As with other securities distributed in the public and private (exempt) markets, there are unique features and requirements that apply to each.

Public versus Private	
Mutual Funds	**Hedge Funds**
Public	Private (Exempt)
Issued by reporting issuers by prospectus in the public market	Issued under an exemption from prospectus requirements in the exempt market
The prospectus is filed and reviewed by the securities commissions/regulators	The offering documents are not filed or reviewed by the securities commissions/regulators
Subject to continuous disclosure requirements including: • annual audited financial statements • half-yearly un-audited financial statements	Continuous disclosure not mandated
Independent Review Committee (IRC) is required	Independent Review Committee (IRC) is not mandated
No resale restrictions, freely tradable	Resale restrictions imposed
Investors: • No restrictions on who can invest (provided that they are of legal age, capacity)	Investors: • Offering is restricted to certain types of investors (e.g. accredited investors, eligible investors under the offering memorandum exemption, etc.)

AIMA CANADA

The Canadian chapter of the Alternative Investment Management Association (AIMA Canada) is the trade association for the Canadian hedge fund industry. It was founded in March 2003 and contributes to:

- enhanced business practices among hedge fund managers, for instance through guidelines concerning practices
- a better understanding of hedge funds by investors

AIMA's international headquarters are in London. Its membership includes hedge fund managers, institutional investors, prime brokers, exchanges, fund administrators, auditors, lawyers, and other service providers.

Hedge Fund Transactions 2

CONTENT AREAS

INTRODUCTION

In this lesson, you will learn about the transactions that hedge funds use in their investment strategies.

This lesson takes approximately 20 minutes to complete.

LEARNING OBJECTIVES

At the end of this lesson, you will be able to:

1 | Describe short selling.

2 | Describe leverage.

3 | Describe derivatives.

4 | Describe arbitrage.

HEDGE FUND TRANSACTIONS

The beginning of a hedge fund investment strategy starts with the financial transactions at its disposal. Hedge funds use transactions which are not available to traditional mutual funds including:

- short selling
- leverage
- derivatives

SHORT SELLING

Short selling is carried out by a seller who sells a stock they do not own. The seller will short sell a stock with the expectation that the stock price will drop. When the stock price drops, the short seller will buy the stock on the market for less than it was sold for, thus making a profit from the difference in the price.

When the stock is sold in the short sell, in order to deliver the stock to the buyer, the short seller will borrow it from an investment dealer. When the stock is bought, the short seller will give the stock to the investment dealer to "cover" the short position. The impact of short selling is illustrated in the examples below.

EXAMPLE

Robert believes that the stock price of Goldblind Inc. is about to drop dramatically because the company's exploration efforts are going nowhere. He decides to sell 100 shares short at the current price of $50 per share. Six months later, the stock price drops to $45. Robert covers his short position and makes a profit of $500 in the process.

Proceeds of short sale (100 shares × $50)	$5,000
Less: Purchase price (100 shares × $45)	$4,500
Profit	$500

EXAMPLE

Using the same scenario for Goldblind Inc. above, assume instead that the company strikes gold and the stock price rises to $100. Robert decides to cover his short position before the stock goes even higher. His loss is $9,500.

Proceeds of short sale (100 shares × $50)	$5,000
Less: Purchase price (100 shares × $100)	$10,000
Loss	$5,000

As this example illustrates, there is an asymmetry in short selling. The best that can happen for the short seller is that the stock price drops to zero. The short seller's profit is therefore limited to the proceeds of the short sale. However, there is no limit to how high the stock price may rise. This means that the loss from a short position is potentially infinite.

The ability to take short positions is very important to hedge funds for the following reasons:

- short positions are essential to implement arbitrage strategies
- short selling enables hedge funds to profit from overvalued stocks

While short selling can be seen as a risky strategy, it can also be used to reduce the risk of a portfolio. A long-only portfolio is fully exposed to the risk of a market downturn. However, it is possible to manage this risk by means of short selling as a hedge (i.e. protection) against a market downturn.

LEVERAGE

Leverage means increasing a fund's investment exposure without increasing the money invested by the fund's investors. There are two ways to implement leverage:

- borrowing, including buying on margin: The proceeds from the loan are used to buy additional investments, thereby increasing the fund's exposure
- derivatives, such as options

Leverage magnifies profits and losses as illustrated in the examples below.

EXAMPLE

The Investsafe Fund does not use leverage. Its portfolio has a net asset value of $100,000 and generates an 8% return.

Gross return from the portfolio ($100,000 × 8%)	8,000
Net asset value of Investsafe Fund at beginning	100,000
Return of Investsafe Fund ($8,000 ÷ $100,000 × 100%)	8%

EXAMPLE

The Levinvest Fund uses $1 of borrowing for every $1 of investors' money. Investors have invested $50,000, which represents the net asset value of the fund. The fund borrows an additional $50,000 at a rate of interest of 5%. The fund's portfolio is therefore $100,000 and is invested in exactly the same stocks as the Investsafe Fund, earning 8%. The return earned from the Levinvest Fund is 11%.

Gross return from the portfolio ($100,000 × 8%)	8,000
Less: Interest on loan ($50,000 × 5%)	(2,500)
Net return	5,500
Net asset value of Leinvest Fund beginning	50,000
Return of Leinvest Fund ($5,500 ÷ $50,000 × 100%)	11%

While leverage magnifies profits, the reverse is also true and leverage magnifies losses. If the return from the additional assets is lower than the interest rate on the loan, the fund will generate a lower return which could even be negative, possibly significantly so.

EXAMPLE

Using the same scenario for the Investsafe Fund and Levinvest Fund above, if the funds' portfolios were to each lose 8%, the return for the Investsafe Fund would be –8%. However, the return for the Levinvest Fund would be –21%.

Gross return from the portfolio ($100,000 × 8%)	(8,000)
Less: Interest on loan ($50,000 × 5%)	(2,500)
Net return	(10,500)
Net asset value of Leinvest Fund beginning	50,000
Return of Levinvest Fund (($10,500) ÷ $50,000 × 100%)	(21%)

Often it is difficult to determine the level of leverage in a hedge fund investment because the level of leverage for each investment strategy within the hedge fund portfolio will be different.

EXAMPLE

An institutional investor allocates $100 million to a multi-strategy hedge fund, which allocates the funds between 20 traders:

Trader A, who has a fixed income arbitrage strategy, receives a notional allocation of $50 million, leveraged 10 to 1 (i.e., $5 million times 10 times leverage). Trader A then levers up his $50 million in notional another 3 times by trading a $150 million portfolio.

Trader B, who has a convertible arbitrage strategy, receives a notional allocation of $15 million, or is leveraged 3 to 1. Trader B then levers up his $15 million by a factor of 5 to 1 by trading a $75 million portfolio.

And so on until all 20 traders have been allocated a notional amount of the $100 million investor capital.

DERIVATIVES

Derivatives are financial instruments which derive their values from an interest in an underlying asset (e.g. stocks, commodities, currencies, etc.). Derivatives include options, futures, forwards, and swaps.

For example, a call option gives the holder the right, but not the obligation, to buy an asset (e.g. a stock) at a given price, called the **exercise price**, within a given period known as the **term**.

While the use of derivatives can be extremely risky when used to speculate, derivatives can also be used to reduce the risk of a portfolio. Such is the case when a covered call option is used as a hedge (i.e. protection) against a decline in the price of a long position.

ARBITRAGE

Arbitrage is used to earn profits when there are discrepancies between the prices of two related assets.

EXAMPLE

The stock price of Genbite Corp. on the TSX exchange is CA $52.55. At the same time, the stock price on the NYSE exchange is US $50. The currency exchange rate is US $1.00 = CA $1.05. Therefore:

- The stock price on the NYSE is $52.50 Canadian
- The stock price on the TSX is %52.55 Canadian

The discrepancy for arbitrage is $0.05 Canadian.

Arbitrage operates in the simplest of ways. The asset is bought on the market where it is cheaper and simultaneously sold where it is higher.

Arbitrage margins are typically very slim and they are also fleeting. Once arbitrageurs begin taking advantage of an opportunity, they very quickly eliminate the price discrepancy. There are also instances where there is only the appearance of a discrepancy. Once transaction costs are taken into account, there may not be any arbitrage opportunity.

Arbitrage is a way to exploit market inefficiencies. Typically, the inefficiencies are very small. In order to enhance the return from arbitrage strategies, hedge funds often use leverage.

Hedge Fund Investment Strategies

3

CONTENT AREAS

- Investment Strategy Categories
- Relative-Value Strategies
- Event-Driven Strategies
- Opportunistic Strategies
- Investment Risk Depends on the Investment Strategy

INTRODUCTION

In this lesson, you will learn about hedge fund investment strategies.

This lesson takes approximately 35 minutes to complete.

LEARNING OBJECTIVES

At the end of this lesson, you will be able to:

1 | List and define the categories of hedge fund strategies.

2 | Explain the following relative-value strategies:

- Convertible arbitrage strategy
- Fixed-income arbitrage strategy
- Equity market-neutral strategy

3 | Explain the following event driven strategies:

- Merger arbitrage
- Distressed securities/high-yield securities

4 | Explain the following opportunistic strategies:

- Long/short equity
- Global macro
- Managed futures
- Emerging markets

5 | Describe how the investment strategy impacts risk.

INVESTMENT STRATEGY CATEGORIES

Hedge fund investment strategies may be grouped into three main categories:

- Relative-value strategies
- Event-driven strategies
- Opportunistic strategies

The main hedge fund investment strategy categories are summarized in the table below.

Investment Strategy Categories

Category	Definition	Investment Strategies
Relative-Value Strategies	Relative-value strategies aim to profit from discrepancies in the prices of two related securities. They are characterized by the use of arbitrage.	• convertible arbitrage • fixed-income arbitrage • equity market-neutral

Investment Strategy Categories		
Category	**Definition**	**Investment Strategies**
Event-Driven Strategies	Event-driven strategies seek to profit from a corporate event such as mergers or financial difficulties	• merger arbitrage • distressed securities/high-yield securities
Opportunistic Strategies	Opportunistic strategies seek to profit from exploiting opportunities identified in the markets	• long/short equity • global macro • managed futures • emerging markets

RELATIVE-VALUE STRATEGIES

Relative-value strategies aim to profit from discrepancies in the prices of two related securities. They are characterized by the use of arbitrage.

CONVERTIBLE ARBITRAGE

Convertible bonds provide the holder with the option to convert the bonds into common shares of the issuer at a specified conversion price. When the convertible bond is originally issued, the conversion price to common shares is higher than the market price of the shares. At that point, conversion is unprofitable or "out of the money" because it is cheaper to buy the shares on the market than to convert. However, if the share price increases to a point where it exceeds the conversion price, conversion would be profitable or "in the money".

When using convertible arbitrage, the hedge fund:

- buys the convertible bonds; and
- short sells the common shares

If the price of the shares go up, the hedge fund will:

- cover the short position at a higher price and lose money on the short sale
- make a gain on the increased price of the convertible bonds

- the gain will offset the loss
- the hedge fund achieves a return from the interest paid on the convertible bond

If the price of the shares go down, the hedge fund will:

- cover the short position at a lower price and make a gain on the short sale
- take a loss on the decreased price of the convertible bonds

- the gain will offset the loss
- the hedge fund achieves a return from the interest paid on the convertible bond

The convertible arbitrage strategy provides a hedge (i.e. protection), whether the market goes up or down, and achieves a return from the interest paid on the convertible bonds. The profit margin from this strategy is usually very thin. In order to achieve a reasonable return, hedge funds which use this strategy often use leverage to enhance the return.

FIXED INCOME ARBITRAGE

Fixed income arbitrage is a strategy which seeks to profit from price anomalies between related interest rate securities. The hedge fund assumes opposing long and short positions to take advantage of the price discrepancies while hedging against interest rate risk. Fixed income arbitrage includes interest rate swap arbitrage, government bond arbitrage, forward yield curve arbitrage, and combinations of each. The profit margin from this strategy is typically small and hedge funds commonly use leverage to enhance return.

EQUITY MARKET-NEUTRAL

The goal of the equity market-neutral strategy is to generate returns regardless if the market goes up or down. Long and short equity portfolios of relatively the same size, sector, and market capitalization, etc. are matched against each other within the hedge fund portfolio. As such, the portfolio is hedged against the market.

The premise of the strategy is:

- in rising markets: long positions will rise more in price than short positions
- in falling markets: short positions will fall more in price than long positions

Hedge funds commonly use leverage to enhance the return of a market-neutral strategy.

EVENT-DRIVEN STRATEGIES

Event-driven strategies seek to profit from a corporate event such as mergers or financial difficulties.

MERGER ARBITRAGE

The objective of the merger arbitrage strategy is to profit from the price differentials of companies in proposed mergers and acquisitions. When a company makes an offer to acquire a target company, the share price of the target company typically rises and the share price of the acquiring company typically declines.

The offer can be made in cash, in shares, or a combination of both.

CASH OFFER

When a merger/acquisition offer is made in cash, the acquiring company will set a fixed price for the target company. The stock of the target company will typically trade at a lower price than the offer price because the market will price in a discount to account for the risk of the merger not going through. The hedge fund will purchase the shares of the target company and hold the position until the deal is complete. When the merger is complete, the hedge fund will exchange the shares for cash and retain the profit from the price between the discount price and the offer price.

SHARE OFFER

When the offer is made in shares, in whole or in part, the hedge fund will:

- buy the shares of the target company long
- sell the shares of the acquiring company short

Again, the objective is to profit from the price differential between the offer price and the discounted market price of the target company as illustrated in the example below.

EXAMPLE

Predator Inc. makes an offer to buy Prey Corp. for 2 shares of Predator Inc. for every 1 share of Prey Corp. The shares of Predator Inc. trade at $25. Therefore, the implied offer price for Prey Corp. is $50 (2 × $25). The shares of Prey Corp. are trading at $43 in the market.

The Hedgebest Fund:

- buys 1 share of Prey Corp. for $43
- sells short 2 shares of Predator Inc. for $50

The offer is accepted and the merger is completed.

The Hedgebest Fund:

- tenders its 1 share of Prey Inc. for 2 shares of Predator Inc.
- uses the 2 shares of Predator Inc. to cover the short position

The profit is $7:

Short sale of two shares of Predator (2 shares × $25)	$50
Purchase of one share of Prey (tender)	$43
Profit	$7

The main risk of the merger arbitrage strategy is that the merger or acquisition is not completed, in which case the share price of the target company will typically drop and the hedge fund will lose money on its long position in the target company. The hedge fund could also lose money on its short position in the acquiring company if the shares increase in price for whatever reason (e.g. investors thought the acquiring company's offer for the target was too high). As such, success in event-driven investing depends on the ability to analyze the event and predict its outcome, not on market conditions in general.

DISTRESSED SECURITIES

Distressed securities are another form of event-driven investing. Distressed investing involves buying the bonds and sometimes the shares of companies which are in financial distress including:

- companies that have defaulted on their obligations (e.g. have not paid interest on a bond on the due date, have not repaid the principal of a bond on the maturity date)
- companies in bankruptcy
- companies in creditor protection

As there are relatively few buyers for companies in distress, it is often possible to buy distressed securities at favourable prices. Where the company succeeds in restructuring its operations and its financial condition, the price of the bonds will rise and the hedge fund will make a profit. Where the restructuring is unsuccessful and the company is wound up, the hedge fund may still make a profit depending on the price it paid for the bond and the size of any liquidation distributions. Creditors such as bondholders must be repaid in full before any money may be paid to the shareholders. For these reasons, hedge funds in distressed investing are sometimes characterized as vulture funds.

The risks of distressed investing are significant and success depends on the ability to analyze the situation and predict its eventual outcome including:

- the viability of the underlying business
- its break-up value
- the availability of fresh capital

Some vulture funds actively attempt to influence the outcome of the restructuring. This may have contributed to the reputation of hedge funds as somewhat frightening entities. Other funds adopt a more passive approach.

OPPORTUNISTIC STRATEGIES

Opportunistic strategies seek to profit from exploiting opportunities identified in the markets.

LONG/SHORT EQUITY

In the long/short equity strategy, the hedge fund judges which stocks are undervalued and which stocks are overvalued and then:

- buys the undervalued stocks long
- sells the overvalued stocks short

The hedge fund expects that the market will at some point recognize the fair value of the stocks and:

- the price of the undervalued stocks will rise to their fair value
- the price of the overvalued stocks will drop to their fair value

If the price of the undervalued stocks rise and the price of the overvalued stocks drop:		
The price of: • the undervalued stocks rise	→	The hedge fund will: • make a gain on the long position
The price of: • the overvalued stocks fall	→	The hedge fund will: • make a gain on covering the short position

Where the price of the undervalued stocks held long drop or the price of the overvalued stocks held short rise, the positions will be covered at a loss. However, the premise of the strategy is that, as the market recognizes the fair value of the stocks, the:

- undervalued stocks will rise by more than overvalued stocks
- undervalued stocks will drop by less than overvalued stocks

The long/short equity strategy provides a hedge in comparison to a long-only strategy and the potential outcomes can be profitable irrespective of whether the market is flat, rising, or falling. As with other hedge fund strategies, leverage is commonly used to enhance the return. The hedge fund's return, however, depends on the portfolio manager's ability to distinguish overvalued stocks from undervalued stocks.

It is important to note that the portion of the portfolio in undervalued stocks held long may not be equal to the portion in overvalued stocks held short. Generally, hedge funds will have some exposure to the equity markets (e.g. 60% long in stocks and 30% short stocks). Thus, the portfolio manager is also making a directional call on the stock market.

Some implementations of the equity long/short strategy apply the same stock selection judgement but also seek to minimize the fund's exposure to the broad market. This can be done in two ways:

- the hedge fund holds equal amounts in both long and short positions
- the hedge fund makes both long and short investments so that the beta of the overall fund is as low as possible

Both of these are referred to as "equity hedge" or "market neutral" strategies and the net exposure is zero.

All of these strategies can be used within a region, sector, or industry. Some hedge fund managers will attempt to increase the return from long/short equity strategies by leveraging the long and short positions.

The risks to the long/short equity strategy are twofold: The portfolio manager could be incorrect on the direction of the market and could be incorrect on stock selection.

GLOBAL MACRO

Global macro strategies give the hedge fund wide discretion to seek investment opportunities across the globe and across all asset classes. A global macro trading strategy involves investing in equities, fixed-income, foreign exchange, and commodity markets around the world. Macro hedge fund managers focus on underlying macro-economic fundamentals in developing their investment strategies including monetary policy shifts, fiscal policy shifts, gross domestic product growth, and inflation. Macro hedge fund managers establish opportunistic long or short market positions to benefit from anticipated moves in the market. The hedge fund managers tend to make significant use of derivatives and leverage.

EXAMPLE

One of the most famous cases of successful global macro investing to date occurred when George Soros reputedly made $1 billion in profit by speculating against the British pound. Soros and other speculators sold the British pound short based on his assessment that he believed the pound was overvalued when Britain entered the European Exchange Rate Mechanism (ERM). Eventually, the British government withdrew from the ERM and the pound declined as a result. The strategy cemented Soros' reputation as one of the premier global macro hedge fund investors.

Global macro investing risks are highly dependent on two factors, the macro-economic judgment of the hedge fund and the timing of the investment call. The macro hedge fund manager may be correct in his assessment of macro conditions, but the timing of the market strategies may be incorrect. Moreover, there may be a heavy degree of leverage involved in many macro trades, which also adds to the overall risks to the investors in a hedge fund using global macro strategies.

MANAGED FUTURES

Managed futures strategies are operated by specialist advisers (portfolio managers) known as commodity trading advisers (CTAs). CTAs invest in futures contracts; derivative instruments that are traded on a futures exchange which derive their price from the underlying asset such as a commodity, currency exchange rate, interest rate, etc. The parties to a futures contract agree to buy or sell an asset to be delivered at a specified future date at a pre-agreed price.

EXAMPLE

Sweetreats Inc. agrees to buy a certain quantity of sugar to be delivered immediately at a price of 4 cents per pound. Since delivery is immediate, the price is known as the spot price.

Sweetreats Inc. learns that the sugar cane crop in Brazil has failed and that sugar prices are likely to climb drastically. Sweetreats buys a futures contract which obligates it to buy a certain quantity of sugar to be delivered in three months' time at a price of 4.25 cents per pound. Since delivery is at a future date, the price is known as the forward price. By buying the futures contract, Sweetreats has assured itself of a supply of sugar at a time when it knows that it will need it, at a known price.

Managed futures hedge funds use futures contracts in their investment strategy. The futures contracts are bought long and sold short based on sophisticated technical and statistical analysis of the future price of the underlying assets. While many managed futures hedge funds focus on identifying "long-term" trends (six months to one year), other hedge funds have constructed models to predict short-term momentum and counter-trend price moves. Derivative instruments may be used by managed futures funds to leverage their portfolios.

The risks of investing in futures contracts stem from the dependence on the hedge fund's abilities to project future markets for the underlying assets, compounded by the use of leverage to enhance returns.

EMERGING MARKETS

Emerging markets are another form of opportunistic investing. The investment strategy involves investing in emerging market countries including those of the BRICS (Brazil, Russia, India, China and South Africa) and South Korea, Mexico, Indonesia, and Turkey. In order to profit from growth opportunities in those countries, the hedge fund will invest in emerging market debt, the equities of companies in emerging markets, the equities of companies exposed to emerging market economies, or the currencies of emerging market countries.

Hedge funds can profit from high growth opportunities or from inefficiencies in markets that are not as well researched as developed markets. Liquidity and market capitalization in these markets can be very limited, short term capital flows tend to be volatile, and the governments in some emerging countries have periodically imposed structural impediments to short selling. The net result is that most emerging market managers tend to have a long bias to equities.

To be successful, hedge funds in emerging markets must possess a strong understanding of the macro-economic environment to determine if the market has mispriced the currency, the default risk on a bond, or the growth potential of a stock. Leverage is commonly used to enhance the return on emerging market portfolios.

The risks of investing in emerging markets are twofold: The dependency on the hedge fund's macro-economic judgment and its judgment on the selection of the portfolio's holdings.

INVESTMENT RISK DEPENDS ON THE INVESTMENT STRATEGY

From an investment perspective, while hedge funds may commonly be conceived of as highly risky strategies, this would be a misconception. The investment risk of a hedge fund depends on the investment strategy it employs. Certain relative-value and arbitrage strategies are relatively low risk.

Many hedge funds performed very poorly in the bear market of 2008. This led some investors to question whether hedge funds truly generate absolute returns. Hedge funds encompass a wide variety of investment strategies. Many of them, such as arbitrage strategies, are premised on the objectives of generating positive returns irrespective of market conditions. However, there are also hedge fund strategies, including most opportunistic strategies, which are directional in nature. Success in directional investing depends on correctly predicting the direction of movements in the market. If the hedge fund's prediction turns out to be incorrect, the fund will lose money. The skill of the portfolio manager is paramount. Even investment strategies which are meant to deliver absolute returns in all market conditions can fail if applied incorrectly.

Risk and Return

4

CONTENT AREAS

INTRODUCTION

In this lesson, you will learn about measuring the risk and return of hedge funds.

This lesson takes approximately 20 minutes to complete.

LEARNING OBJECTIVES

At the end of this lesson, you will be able to:

1 | Explain the maximum drawdown measure.

2 | Explain the time under water measure.

3 | Define risk-adjusted return.

4 | Explain the standard deviation measure.

5 | Explain the beta measure.

6 | Explain the Sharpe ratio.

7 | Explain the Treynor ratio.

8 | Explain the Sortino ratio.

OVERVIEW OF RISK AND RETURN

When measuring the return of a hedge fund, the assessment of the return should consider the risk that was assumed by the hedge fund in order to generate the return. Assessing the risk of a hedge fund will involve complex financial and statistical analysis.

Financial analysis is based on data in the financial statements of an issuer to determine, among other things, its capital structure, liquidity, and profitability.

Statistical risk analysis involves measures that are found in modern portfolio theory which are derived from the analysis of historical market data to analyze volatility and downside risk.

STATISTICAL RISK MEASURES

Two statistical measures that are commonly used as indicators of hedge fund risk are:

- maximum drawdown
- time under water

MAXIMUM DRAWDOWN

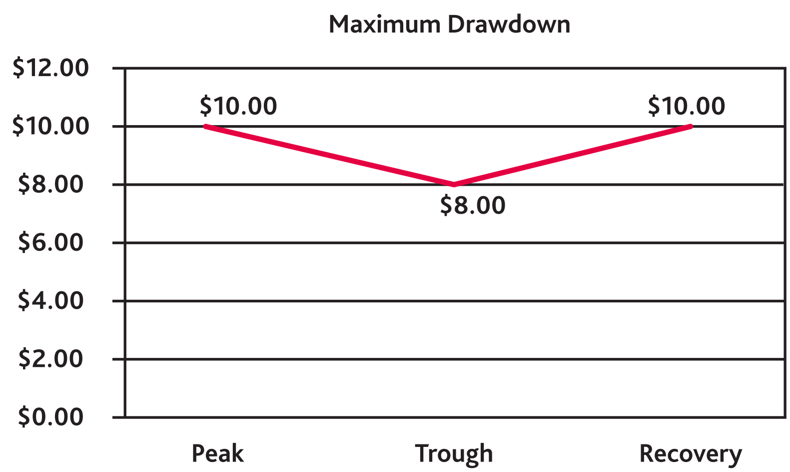
Maximum drawdown is:

- a measure of the maximum amount a hedge fund has lost historically
- represented by the maximum drop in the net asset value (NAV) per unit from peak to trough

EXAMPLE

Hedgeinvest Fund's NAV per unit reaches a peak of $10, then drops and reaches a trough of $8, at which point it begins to recover.

Figure 11.1



The loss from peak to trough is calculated as follows: $10 – $8 = $2 (20%)

The maximum drawdown is 20% of the peak value.

TIME UNDER WATER

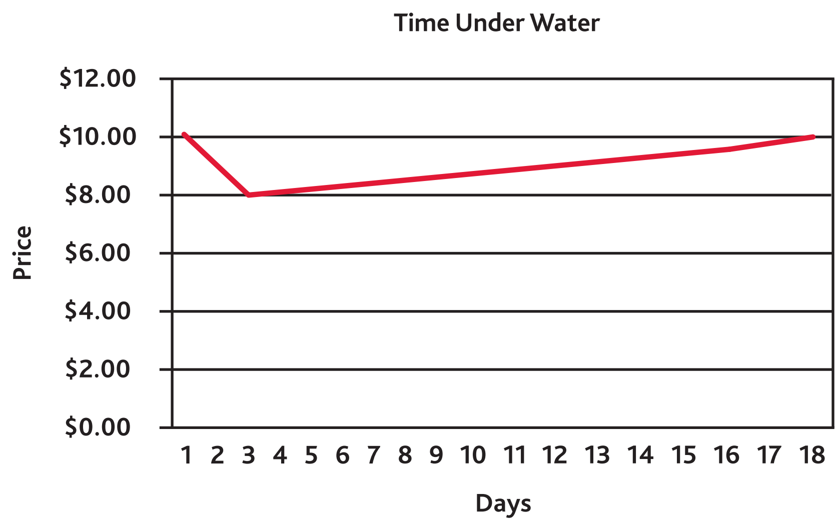
Time under water complements maximum drawdown as an indicator of risk. Time under water:

- measures the maximum time it takes for a hedge fund to recover its money after a loss
- represents the maximum time it takes after a drop from a peak, to recover to the level of the peak

EXAMPLE

Hedgeinvest Fund's NAV per unit drops from $10 to $8 in 2 days and then it takes 16 days for the price to recover back to $10.

Figure 11.2



The time under water is 18 days.

When used together, the maximum drawdown and the time under water give a useful statistical indication of a hedge fund's risk.

RISK-ADJUSTED RETURN

A risk-adjusted return is a measure of return which has been adjusted to consider the fund's risk. It makes it possible to compare two funds with different degrees of risk.

EXAMPLE

Fund A has a return of 10%. Fund B has a return of 12%. Which fund did better?

It is impossible to say because there is insufficient data. The data is not sufficient because the two funds may have different risk levels. If a fund achieves a higher return because of higher risk, this is not necessarily a good thing because the fund's incremental return may not compensate for its incremental risk.

Risk-adjusted return encompasses two elements:

- the risk-free rate
- statistical risk measures

RISK-FREE RATE

The risk-free rate is the return obtained from investing in a risk-free asset. A risk-free asset is an asset whose return is certain. In practice, a Government of Canada treasury bill is often used as a proxy for a risk-free asset because the risk of default is so low that it can be ignored for most practical purposes.

STATISTICAL RISK MEASURES

Two commonly used statistical measures of risk are:

- standard deviation
- beta

STANDARD DEVIATION

Standard deviation is a measure of the variability of an asset's price or returns. Here, risk is equated with variability from the mean (or volatility). If the prices/returns are further from the mean, there is a higher deviation; thus, the more spread out the prices/returns, the higher the standard deviation.

EXAMPLE

Stocks M and N both have an expected return of 10%. The standard deviation of stock M is 2% and that of stock N is 4%. The returns of stock N are more variable from the mean (or volatile) than those of stock M. Stock N is therefore riskier than stock M.

BETA

The beta of an asset measures how its return responds to changes in the return of the market as a whole. A broad-based index such as the S&P/TSX Composite is often used as a proxy for the market. The beta of the market is 1.

EXAMPLE

Stock E has a beta of 1. This means that its return moves in tandem with that of the market. If the market return goes down by 10%, the return of stock E will also go down by 10%. Stock E has the same risk as the market.

Stock F has a beta of 0.8. This means that if the market return goes up or down by 10%, its return will go up or down by 8%, or 0.8 × 10%. Stock F is less risky than the market.

Stock G has a beta of 1.2. This means that if the market return goes up or down by 10%, its return will go up or down by 12%, or 1.2 × 10%. Stock G is riskier than the market.

RISK-ADJUSTED RETURN MEASURES

An investor who invests in a risk-free asset earns the risk-free rate. To earn more than the risk-free rate, an investor must accept more risk. The risk of an asset can be measured by its standard deviation or by its beta.

The greater the risk of the asset, the greater the excess of its expected return over the risk-free rate should be. This is the fundamental principal in analysing investment performance.

Some common risk-adjusted return measures are:

- the Sharpe ratio
- the Treynor ratio
- the Sortino ratio

THE SHARPE RATIO

The Sharpe ratio uses standard deviation as its measure of risk. It measures the asset's excess return per unit of risk, where risk is its standard deviation of return.

Formula: Sharpe Ratio

$$Sp = \frac{Rp - Rf}{\sigma p}$$

Where:

Sp = Sharpe ratio of the portfolio

Rp = Return of the Portfolio

Rf = Risk-Free Rate

σp = Standard Deviation of the portfolio

The higher the Sharpe ratio of the portfolio, the better the risk adjusted return. A variant of the Sharpe ratio is the Information ratio in which the risk-free asset is replaced by a benchmark portfolio.

THE TREYNOR RATIO

The Treynor ratio uses beta as its measure of risk. It measures the asset's excess return per unit of risk, where risk is its beta.

Formula: Treynor Ratio

$$Tp = \frac{Rp - Rf}{\beta p}$$

Where:

Tp = Treynor ratio of the portfolio

Rp = Return of the Portfolio

Rf = Risk-Free Rate

βp = Beta of the portfolio

The higher the Treynor ratio of the portfolio, the better the risk adjusted return.

THE SORTINO RATIO

Both the Sharpe and Treynor ratios use statistical risk measures that encompass both the upside and downside volatility. The Sortino ratio is the Sharpe ratio, with the difference being that it uses downside deviation (using only downside volatility), rather than standard deviation.

Formula: Sortino Ratio

$$Sp = \frac{Rp - Rf}{Dp}$$

Where:

Sp	=	Sortino ratio of the portfolio
Rp	=	Return of the Portfolio
Rf	=	Risk-Free Rate
Dp	=	Downside Deviation of the portfolio

Similar to the Sharpe and Treynor ratios, the higher the Sortino ratio, the better the risk-adjusted return.

Operations of a Hedge Fund 5

CONTENT AREAS

INTRODUCTION

In this lesson, you will learn about the operations of a hedge fund.

This lesson takes approximately 15 minutes to complete.

LEARNING OBJECTIVES

At the end of this lesson, you will be able to:

1 | Explain the roles of hedge fund participants.

2 | Define and describe the different hedge fund manager structures.

3 | Discuss single-strategy and multi-strategy hedge funds.

4 | Discuss principal protected notes.

PARTICIPANTS

The main participants in a hedge fund are the:

- investment fund manager
- portfolio manager
- prime broker
- administrator
- custodian
- other service providers

INVESTMENT FUND MANAGER

The investment fund manager, also known as the sponsor or manufacturer, takes the initiative in setting up the hedge fund and is responsible for the operation of the fund. National Instrument 31-103 (NI 31-103) requires the investment fund manager to be registered with the securities commissions in the category of investment fund manager. While charged with the responsibility for the hedge fund's operations, in practice, the investment fund manager often outsources many of the tasks involved in running the fund to service providers such as the prime broker and the administrator.

The principals of the investment fund manager usually invest their own money in the fund alongside other investors. This aligns their interests with those of outside investors. As part of the due diligence of a hedge fund, it would be prudent to check whether the principals have invested their own money in the fund and if so, how much. This would be a measure of their commitment to the fund and the strength of their conviction in their abilities.

While the investment fund manager of any investment fund has wide discretionary powers, this is particularly true of hedge funds because they have broad investment mandates, are privately distributed, and are therefore less transparent than public investment funds. It is therefore essential to be fully confident in the integrity and competence of the investment fund manager and this should be a matter of focus in the due diligence process.

PORTFOLIO MANAGER

The portfolio manager is responsible for the composition and mandate of the hedge fund's portfolio. NI 31-103 requires the portfolio manager of a hedge fund to be registered with the securities commissions in the category of portfolio manager. The portfolio manager is commonly a related party to the investment fund manager.

Similar to the investment fund manager, the portfolio manager has wide discretionary powers over the hedge fund. The nature of the sophisticated investment strategies of a hedge fund and the responsibility for the broad mandates dictates that skill, expertise, and integrity are paramount. It is therefore essential to be fully confident in the integrity and competence of the portfolio fund manager and this should be a matter of focus in the due diligence process.

PRIME BROKER

The prime broker provides essential institutional services to the hedge fund which include:

- executing and clearing trades for the hedge fund's portfolio
- providing reports of the positions held by the fund
- providing financing to the hedge fund for leverage
- lending the stocks to the hedge fund to sell securities short
- introducing new investors to the hedge fund
- acting as the custodian for the securities held by the hedge fund (where appointed as the custodian)

NI 31-103 requires the prime broker to be registered with the securities commissions in the category of investment dealer and to be a member of the Investment Industry Regulatory Organization of Canada (IIROC).

ADMINISTRATOR

The fund administrator provides administrative services to the hedge fund which include:

- processing subscriptions
- processing redemptions
- maintenance of investor records
- pricing the fund's assets (in consultation with the investment fund manager)
- calculation of the fund's net asset value (NAV)
- calculation of management and performance fees
- preparation of financial statements

There is no requirement for the administrator to be registered.

CUSTODIAN

Hedge funds are not subject to the requirements of National Instrument 81-102 (NI 81-102) including those governing custodians. Therefore, the custodian of a hedge fund is not required to be a bank or trust company and there is no regulation to prevent the hedge fund or a related entity from also being the custodian. In practice, the custody of a hedge fund's securities is often entrusted to its prime broker.

OTHER SERVICE PROVIDERS

Other service providers to a hedge fund include its:

- legal counsel
- auditor

When performing due diligence on a hedge fund, it is important to know who the fund's service providers are. Often smaller managers will use unknown service providers to reduce costs. Better known service providers with strong history and reputation are preferable. Independent service providers that deal at arms' length with the hedge fund provide a valuable internal control feature.

MANAGER STRUCTURE

Hedge funds may be classified into three categories:

- single-manager hedge funds
- fund-of-funds (FOF) hedge funds
- multi-manager hedge funds

The characteristics of hedge fund structures are summarized in the table below.

Hedge Fund Manager Structures	

Single-Manager	• has a single portfolio manager
	• has exposure to:
	  ◦ manager risk
	  ◦ strategy risk

Fund-of-Funds (FOF)	• invest in units of underlying single-manager hedge funds • manager risk and strategy risk can be mitigated • benefits from diversification

Multi-Manager	• a variant of the fund-of-funds (FOF) structure
	• does not invest in units of underlying single-manager hedge funds
	• each underlying hedge fund is allocated a certain sum of money to invest according to an agreed strategy
	• manager risk and strategy risk can be mitigated
	• benefits from diversification
	• benefits from reduced operational risk:
	  ◦ each underlying hedge fund is fully transparent to the multi-manager
	  ◦ the multi-manager is aware of all positions and transactions

SINGLE-STRATEGY AND MULTI-STRATEGY

Fund-of-funds (FOF) and multi-manager hedge funds can have the following strategy structures:

- single-strategy
- multi-strategy

SINGLE-STRATEGY HEDGE FUNDS

In a single-strategy hedge fund, the underlying funds have different portfolio managers who follow the same investment strategy. This mitigates manager risk but not strategy risk.

Single-strategy hedge funds may be appropriate in a diversified portfolio or may be of interest to investors who have a strong conviction for a given strategy.

MULTI-STRATEGY HEDGE FUNDS

In a multi-strategy hedge fund, the underlying funds have different portfolio managers who follow different investment strategies. These hedge funds provide diversification by strategy as well as by manager.

The portfolio manager of a multi-strategy hedge fund creates value for investors by:

- making projections on investment strategies which will be successful and allocating the portfolio accordingly
- selecting the single-manager hedge funds to invest in
- monitoring the performance of strategies and managers and adjusting allocations as appropriate

Before selecting an underlying fund, the portfolio manager normally performs extensive due diligence on the hedge fund.

PRINCIPAL PROTECTED NOTES

As with all securities offered in the exempt market, hedge funds are distributed primarily by way of an offering memorandum (OM) and may only be purchased by certain investors who qualify for exemption (e.g. accredited investor exemption, eligible investor under the offering memorandum exemption, etc.).

Principal protected notes (PPNs) are offered under the specified debt exemption and there are no restrictions on who can invest in PPNs.

PPNs are structured products which derive their return from a combination of different investment vehicles, expressed as the net asset value (NAV) of the note. The classic PPN is constructed with two financial instruments:

- a zero-coupon bond – this is used to provide the principal protection at maturity
- a call option – this is used to provide exposure to the underlying asset and potential return

PPNs are also commonly structured with hedge funds as the market component of the note and these PPNs offer investors:

- protection of the investor's principal investment
- the opportunity to share in the returns from the underlying hedge funds

The principal of a PPN is protected in the sense that the note is a direct, unconditional obligation of the issuer which is guaranteed by a Schedule I or II bank. By investing in PPNs, investors can also gain access to hedge funds without qualifying for exemptions (such as the accredited investor exemption). The return on the hedge funds is typically only available if the PPN is held until maturity. Some PPNs also have features which trigger a "protection event" if markets are volatile and the net asset value of the PPN hits a certain trigger level. When triggered, the PPN is restructured so that it no longer has exposure to the underlying assets (i.e. hedge funds) and the investor loses the potential to earn any returns on the PPN. In such cases, the investor will only receive the principal amount at maturity.

PPNs are offered under an exemption from prospectus requirements and, similar to exempt securities including hedge funds, are not subject to the reporting issuer regime.

Tax Considerations of Hedge Funds

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CONTENT AREAS

INTRODUCTION

In this lesson, you will learn about the tax considerations of hedge funds.

This lesson takes approximately 5 minutes to complete.

LEARNING OBJECTIVES

At the end of this lesson, you will be able to:

1 | Understand how the taxation of a hedge fund depends on its legal form.

2 | Explain the tax treatment of hedge fund limited partnerships.

3 | Explain the tax treatment of hedge fund trusts.

4 | Discuss the SIFT rules with respect to hedge funds.

TAX CONSIDERATIONS

The tax considerations of any investment should be determined in consultation with a professional tax adviser. For information purposes, the general tax considerations in relation to hedge funds are outlined below.

LEGAL STRUCTURE AND TAX TREATMENT

Canadian hedge funds usually take one of two legal forms:

- limited partnership
- trust

The legal structure of a hedge fund will dictate its treatment from a tax perspective.

HEDGE FUND LIMITED PARTNERSHIPS

Hedge fund limited partnerships do not pay taxes on income. Like any other limited partnership, they are flow-through entities and as such, income and losses from the limited partnership flow-through to its limited partners (i.e. the hedge fund unit holders). The unit holders receive the income generated by the limited partnership and then must report the income in their tax filings. If the limited partnership incurs a loss, these losses can also be deducted by the unit holders in their tax filings. The income and losses will flow through to the hedge fund unit holders in its original form, for example as:

- interest
- dividends
- capital gains

When a hedge fund investor redeems their hedge fund units, the capital gain or loss must be considered for tax purposes. The amount of the capital gain is the difference between the proceeds of disposition and the total of:

- the adjusted cost base (ACB) of the units; and
- the expenses incurred to dispose of the units.

HEDGE FUND TRUSTS

The Income Tax Act (Canada) normally treats a trust as a separate taxpayer for income tax purposes. This means that any income earned by the trust will be taxed in the trust. However, hedge funds can be structured to meet certain conditions in the Income Tax Act (Canada) which permit flow-through tax treatment to the hedge fund unit holders. As such, income that is earned through the trust and then paid to the hedge fund unit holders is taxed at only one level, to the unit holders. The hedge fund unit holders receive the income generated by the trust and then must report the income in their tax filings. Unlike limited partnerships, however, trusts may not distribute losses to the unit holders.

The income will flow through to the hedge fund unit holders in its original form, for example as:

- interest
- dividends
- capital gains

There is nothing to prevent a trust from distributing more than its income. The excess is treated as a return of capital and is deducted from the adjusted cost base (ACB) of the units. A return of capital distribution is not taxable when it is paid to the investor. However, a capital gain (or loss) will be realized when the investor eventually redeems the units. The capital gain will be greater (or the capital loss smaller) when a return of capital has been paid because the adjusted cost base was reduced.

When a hedge fund investor redeems their hedge fund units, the capital gain or loss must be considered for tax purposes. The amount of the capital gain is the difference between the proceeds of disposition and the total of:

- the adjusted cost base (ACB) of the units; and
- the expenses incurred to dispose of the units.

SIFT RULES

The Specified Investment Flow-Through (SIFT) rules effectively eliminate the flow-through tax advantages on publicly-traded income trusts. Since hedge funds are privately distributed trusts, the SIFT rules do not apply to hedge funds.

Benefits of Hedge Funds 7

CONTENT AREAS

INTRODUCTION

In this lesson, you will learn about the benefits of hedge funds.

This lesson takes approximately 10 minutes to complete.

LEARNING OBJECTIVES

At the end of this lesson, you will be able to:

1 | Explain the benefits of hedge funds including:

- broad investment mandates
- absolute returns
- diversification
- risk adjusted returns

BENEFITS OF HEDGE FUNDS

Hedge funds can provide the following benefits:

- **Broad investment mandates:** Hedge funds are not subject to the restrictions in National Instrument 81-102 (NI 81-102) limiting and prohibiting certain investments and strategies. As such, hedge funds can employ broad investment mandates including buying long, selling short, using leverage to enhance return, concentration, and alternative investments including real estate, derivatives, commodities, and private equity.
- **Absolute returns:** Hedge funds typically seek to generate positive returns, regardless of market conditions. This differs from traditional mutual funds which seek to generate positive returns relative to the market, indices, and benchmarks.
- **Diversification:** Because hedge funds focus on absolute returns using broad investment mandates and alternative investments, there is a low correlation to traditional assets and the markets in general. Therefore, portfolios holding traditional assets which include hedge funds as a component can be better diversified and more efficient.
- **Risk adjusted returns:** Hedge funds can employ a number of investment strategies which can “hedge” (i.e. protect) against risk including relative value arbitrage and equity market-neutral strategies. Because hedge funds can buy long, sell short, and use derivatives, they can cover positions with long and short hedging strategies. As such, hedge funds can mitigate risks that long-only mutual funds cannot.
- **Tax treatment:** The income earned by hedge funds is flowed through to the unit holders and is taxed at one level only (i.e. double tax is avoided), whether structured as a limited partnership or trust. In addition, hedge funds structured as limited partnerships can also flow losses through to the unit holders.
- **Professional management:** Hedge funds are typically professionally managed portfolios.
- **Registered plans:** Hedge funds can be eligible for registered plans such as RRSPs, RRIFs, TFSAs, RESPs, and RDSPs depending on the legal structure of the hedge fund (e.g. trust).

Hedge Fund Fees

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CONTENT AREAS

INTRODUCTION

In this lesson, you will learn about the fees for hedge funds.

This lesson takes approximately 10 minutes to complete.

LEARNING OBJECTIVES

At the end of this lesson, you will be able to:

1 | Discuss hedge fund fees.

2 | Explain management fees and performance fees for single-manager hedge funds.

3 | Explain management fees and performance fees for fund-of-funds/multi-manager (FOF) hedge funds.

HEDGE FUND FEES

Hedge fund fees include the following two fees:

- a management fee
- a performance fee

The size of the fees depends on the following factors:

- whether the hedge fund is a single-manager or a fund-of-funds/multi-manager (FOF) hedge fund
- the series of the fund unit

Hedge funds are generally available in several series of units, in recognition of the fact that different investors have different compensation arrangements with their dealers. The most common classes of hedge fund units are:

- Series A units: purchased by investors with commission-based dealer accounts
- Series F units: purchased by investors with fee-based dealer accounts

The forms of dealer compensation for hedge funds are similar to those in the mutual fund industry.

SINGLE-MANAGER HEDGE FUND FEES

The typical management and performance fees for a single-manager hedge fund are summarized in the table below.

Single-Manager Hedge Fund Fees		
Fee	**Series A Units**	**Series F Units**
Management Fee (annual) (% of assets under management (AUM))	1% to 2% of AUM	0.75% to 1% of AUM
Performance Fee	20% of the hedge fund's return	

The reason that the investors of Series F units pay lower management fees is because they pay their dealers additional fees based on assets under administration, similar to the hedge funds' management fees. The hedge fund charges the investors lower management fees and does not pay asset-based commissions (i.e. trailer commissions) to the dealers. The management fees not charged to the Series F unit investors is offset by the trailer commissions not paid to the dealers for their Series F unit clients.

PERFORMANCE FEES

There are 3 main factors to consider when analysing a hedge fund's performance fee:

- over what period the performance fee is calculated
- hurdle rate
- high-water mark

The important factors of performance fees are outlined in the table below.

Performance Fees	
Period	• quarterly or annual • if quarterly, the hedge fund will earn a performance fee during the year, even if the annual performance is negative
Hurdle Rate	• the minimum rate of return the hedge fund must exceed before it is entitled to a performance fee • many Canadian hedge funds do not feature a hurdle rate
High-Water Mark	• the peak in the NAV per unit previously attained • designed to prevent the hedge fund from earning a performance fee on the same profits more than once • the NAV per unit must be higher than the high-water mark for a performance fee to be earned

The following example illustrates how performance fees are calculated.

EXAMPLE

Hedgeinvest Fund starts at a NAV per unit of $100.

At the end of period 1, the NAV per unit is $120: The hedge fund is entitled to a performance fee of 20% of the $20 profit per unit.

At the end of period 2, the NAV per unit is $105: The hedge fund is not entitled to a performance fee.

At the end of period 3, the NAV per unit is $115: The hedge fund is not entitled to a performance fee.

At the end of period 4, the NAV per unit is $130: The hedge fund is entitled to a performance fee of 20% of the $10 profit ($130 – $120 = $10). The new watermark is $130.

When analysing a high-water mark, it is only the NAV per unit that matters, not the NAV of the fund. The NAV of the fund includes subscriptions and redemptions which have no bearing on performance. It is also important to ascertain whether the high-water mark is permanent or reset at periodic intervals. High-water marks that are permanent or reset periodically each have different advantages as illustrated in the table below.

High-Water Marks	
Permanent	**Reset Periodically**
• high-water mark remains in place permanently • renders the hedge fund accountable for performance • risk of the hedge fund being wound up if performance drops considerably below the permanent high-water mark and there is little prospect of performance fees	• high-water mark is reset at periodic intervals • for example: highest NAV per unit over the past 2 years (rather than since inception) • preserves the hedge fund's motivation • if reset too frequently, it is as if there is no high-water mark at all • loss of accountability for performance

FUND-OF-FUNDS AND MULTI-MANAGER (FOF) HEDGE FUND FEES

The typical management and performance fees for a fund-of-funds/multi-manager (FOF) hedge fund are summarized in the table below.

Fund-of-Funds/Multi-Manager (FOF) Hedge Fund Fees		
Fee	**Series A Units**	**Series F Units**
FOF Management Fee (annual) (% of assets under management (AUM))	1% of AUM	0.75% of AUM
FOF Performance Fee	10% of the hedge fund's return	
Underlying Funds Management Fees (annual) (% of assets under management (AUM))	1% to 2% of AUM	0.75% to 1% of AUM
Underlying Funds Performance Fee	20% of the hedge fund's return	

It is important to note that the fees charged by the FOF hedge fund is in addition to the fees charged by the underlying hedge funds in the FOF portfolio. There are two layers of fees: 1 layer of fees for the underlying hedge funds in the portfolio; and a 2nd layer of fees for the FOF hedge fund.

PERFORMANCE FEES

The factors to consider when analysing the performance fee of a FOF hedge fund are the same as a single-manager hedge fund including:

- over what period the performance fee is calculated
- hurdle rate
- high-water mark

However, there are considerations specific to FOF hedge funds in the context of performance fees. The primary service a FOF hedge fund provides is selection of the underlying hedge funds. As such, this implies that the FOF hedge fund should not earn a performance fee if the FOF hedge fund collectively has poor performance. It is therefore important to determine how performance fees are calculated:

- based on the collective performance of the FOF hedge fund as a whole; or
- based on each underlying hedge fund in the portfolio

If the performance fee is based on the latter, the FOF hedge fund can earn performance fees even when the FOF hedge fund is losing money overall.

Risks of Hedge Funds 9

CONTENT AREAS

INTRODUCTION

In this lesson, you will learn about the risks of hedge funds and other issues related to hedge funds.

This lesson takes approximately 10 minutes to complete.

LEARNING OBJECTIVES

At the end of this lesson, you will be able to:

1 | Explain investment risk.

2 | Explain leverage risk.

3 | Explain liquidity risk.

4 | Explain concentration risk.

5 | Explain counterparty risk.

6 | Explain portfolio manager risk.

7 | Explain exempt market risks.

8 | Discuss issues with hedge fund prices.

9 | Discuss issues with management expense ratios (MERs).

10 | Discuss issues with back-tested data.

11 | Discuss side letters.

RISKS OF HEDGE FUNDS

There are certain risks associated with hedge funds. The most apparent risks commonly associated with hedge funds are summarized below.

- **Investment Risk:** Hedge funds are subject to investment risks over and above those encountered in traditional investing including the following:
  - The use of derivatives can result in severe losses of very large amounts in a very short period of time.
  - Investment in alternative assets can result in severe losses and some assets can be particularly illiquid or difficult to sell.
- **Leverage Risk:** The use of leverage exposes the hedge fund to risks which include the following:
  - Leverage strategies can result in severe losses when the interest on the loan exceeds the return on the investment.
  - Leverage using margin loans can result in margin calls and if the margin calls are not covered, the assets could be sold out at an inopportune time at unfavourable prices.
  - The payment of interest and principal on leverage obligations must be satisfied regardless of returns or even losses.

- **Liquidity Risk:** Hedge funds are exposed to liquidity risk in the following two ways:
  - *Liquidity of the hedge fund units:* Hedge funds typically have lock-up periods when the units cannot be redeemed. At the end of the lock-up period, there may also be limited redemption opportunities. Hedge funds typically require investors to notify the fund in advance of redemption requests, for example 30 days prior. In circumstances of adverse market conditions, hedge funds can suspend redemptions all together. Where redemption requests are honored, delays in the payment of the redemption proceeds may occur. In particular, fund-of-funds (FOF) hedge funds often withhold a portion of the redemption proceeds until sometime after the year-end when the financial statements of the underlying funds have been finalized.
  - *Liquidity of the hedge fund's underlying investments:* Hedge funds invest in alternative investments using complex investment strategies. Therefore, some assets can be particularly illiquid and some positions can be particularly difficult to unwind.
- **Concentration Risk:** Hedge funds are not subject to the requirements of National Instrument 81-102 (NI 81-102) concerning concentration restrictions. As such, hedge funds can be concentrated in a certain investment, sector, geographic region, etc. These high correlations reduce diversification and increase risk from concentration.
- **Counterparty Risk:** Since hedge funds use derivatives in their investment strategies, this exposes them to counterparty risk: the risk that the party on the other side of the contract will default on their obligations.
- **Portfolio Manager Risk:** Hedge funds employ investment strategies which often do not correlate to the performance of the market and in some circumstances take an opposite position to traditional investing. Therefore, the performance of a hedge fund is more focused and dependent on the portfolio manager's skill in applying a given investment strategy.
- **Exempt Market Risks:** Hedge funds are privately distributed under exemptions from prospectus requirements which poses risks from the following elements:
  - *Transparency:* Hedge funds are not subject to the reporting issuer regime, they provide less information to their investors, and the information provided is not subject to the oversight of the regulators. Not every hedge fund will reveal their portfolio. This lack of transparency often makes it difficult to ascertain whether the hedge fund is actually doing what it says it will do (i.e. whether it is adhering to its investment mandate, risk control process, trading discipline, and compliance processes).
  - *Independent Review Committee:* There is no Independent Review Committee (IRC) for a hedge fund.
  - *Resale Restrictions:* The resale restrictions for hedge funds are most commonly indefinite, which means that there is no secondary market for the hedge fund units. Therefore, the only means of liquidity for investors would be redemption through the hedge fund which, in most cases, is also subject to restrictions and limitations.
  - *Investor Rights:* Investors in hedge funds are not afforded the same legal rights that are available to investors who purchase prospectus-based investment funds. The right of action for damages for a "misrepresentation" are limited in comparison to prospectus-based investment funds.

OTHER ISSUES

In addition to the risks of investing in hedge funds, there are other issues and matters of concern which relate to investing in hedge funds including:

- hedge fund valuation
- management expense ratios
- back-tested data
- side letters

VALUATION

The accuracy and integrity of hedge fund valuations can give rise to concerns which include:

- conflicts of interest
- accuracy of valuations
- fund-of-funds/multi-manager (FOF) hedge fund valuations

CONFLICTS OF INTEREST

The hedge fund is in a conflict of interest when it:

- is responsible for valuing the hedge fund units; and also
- earns a performance fee which is based on the value of those hedge fund units.

In order to implement controls, many hedge funds outsource the valuation of their portfolio to a third-party administrator. This may not fully address the conflict if the administrator seeks involvement from the hedge fund in the valuation process. However when structured properly, the conflict of interest can be addressed, if not entirely eliminated.

ACCURACY OF ASSET PRICES IN A HEDGE FUND

The value of a hedge fund is determined based on the prices of its underlying assets and positions. Issues of concern can arise with respect to the accuracy of the asset prices within a hedge fund. Certain assets are hard to price because they are illiquid or because there is a lack of external pricing sources. While some assets, for example those in long/short equity strategies, can be straight forward from a pricing perspective, others involving alternative investments and complex strategies will pose difficulties in valuation.

FUND-OF-FUNDS/MULTI-MANAGER (FOF) HEDGE FUNDS

Issues of concern can arise with respect to the valuation of fund-of-funds and multi-manager (FOF) hedge funds. The FOF hedge fund relies on the prices provided by the underlying hedge funds. The FOF hedge fund does not always take independent steps to ensure that the prices of the underlying hedge funds are fairly valued. This leaves the fund open to the possibility of mispricing.

MANAGEMENT EXPENSE RATIOS

The fees and expenses of a hedge fund are invisible to the investor because they are deducted from the fund's assets before the net asset value (NAV) per unit is determined. The investor does not pay for the expenses separately, they are included in the NAV per unit of the hedge fund. However, hedge funds are privately distributed and are therefore not subject to the requirements in National Instrument 81-106 (NI 81-106) concerning the calculation and reporting of management expense ratios (MERs). Therefore, the availability of MER information may be limited and where provided, it may be open to errors or omissions.

BACK-TESTED DATA

When a hedge fund has a limited track record, it may present back-tested performance data in their marketing literature. These are returns which would have been obtained in past periods prior to the creation of the hedge fund, if the fund's investment strategy had been applied during those periods. Back-tested data can be helpful in evaluating the sources of the hedge fund strategy's returns to ensure they are robust and repeatable, if the method of calculation is disclosed and the data has been validated by an independent source. However, back tested data can also be misleading because the results are hypothetical and may not be indicative of how the hedge fund will actually perform in the future.

SIDE LETTERS

Certain hedge funds may have side letters which favour certain investors and give those investors special rights such as:

- lower management or performance fees;
- the right to be informed on the occurrence of specified events such as the departure of a principal, redemption by a principal, or the start of regulatory proceedings against the hedge fund or a principal;
- the right to redeem their investment ahead of other investors on the occurrence of one of the events above.

DUE DILIGENCE

It is important that these elements of risk and other issues are captured in the due diligence reviews of hedge funds.

UNIT SUMMARY

Congratulations, you have reached the end of Unit 11: Hedge Funds

In this unit you covered:

- Lesson 1: Characteristics of hedge funds
- Lesson 2: Hedge fund transactions
- Lesson 3: Hedge fund investment strategies
- Lesson 4: Risk and return
- Lesson 5: Operations of a hedge fund
- Lesson 6: Tax considerations of hedge funds
- Lesson 7: Benefits of hedge funds
- Lesson 8: Hedge Fund Fees
- Lesson 9: Risks of hedge funds

Now that you have completed these lessons, you are ready to assess your knowledge with a 10-question quiz. To start the quiz, return to the IFSE Landing Page and click on the Unit 11 Quiz button.

UNIT 12

KNOW YOUR CLIENT & SUITABILITY

INTRODUCTION

In this unit you will learn about qualifying investors for exemption, Know Your Client (KYC), Know Your Product (KYP), and suitability.

This unit takes approximately 2 hours and 5 minutes to complete.

Lessons in this unit:

1. Overview of Suitability
2. Exemption Qualification
3. Know Your Client
4. Know Your Product
5. Suitability
6. Dealing with Older and Vulnerable Clients

Overview of Suitability 1

CONTENT AREAS

INTRODUCTION

In this lesson, you will be provided with an overview of the suitability process for exempt securities.

This unit takes approximately 10 minutes to complete.

LEARNING OBJECTIVES

At the end of this lesson, you will be able to:

1 | Explain the obligations in the suitability process

2 | Define qualification for exemption

3 | Define Know Your Client (KYC)

4 | Define Know Your Product (KYP)

5 | Define suitability

6 | Explain the distinction between qualification for exemption and suitability and why each is important

OVERVIEW OF THE SUITABILITY PROCESS

When you are considering offering exempt securities, before you offer the securities to an investor, you are obligated to first:

- qualify whether the investor is eligible to invest in exempt securities; and if so
- learn the essential facts about the investor;
- learn the essential facts about the exempt product;
- determine whether the exempt product is suitable for the investor.

It is critical that you understand that qualifying an investor's eligibility and suitability are not one and the same. You must diligently carry out each of the 4 steps in the suitability process and be able to evidence that you did so.

Suitability Process for Exempt Securities	
Exemption Qualification	• qualify whether the investor is eligible to invest in exempt securities
Know Your Client (KYC)	• learn the essential facts about the investor
Know Your Product (KYP)	• learn the essential facts about the investment product and/or investment strategy
Suitability	• determine whether the investment product and/or investment strategy is suitable for the investor

The requirements pertaining to KYC, KYP, and suitability are established in National Instrument (NI) 31-103. The requirements pertaining to exemption qualification are established in National Instrument (NI) 45-106. From a regulatory standpoint, the qualification of an investor for exemption is not encompassed in the regulations for KYC and suitability; there are separate requirements under NI 45-106. Notwithstanding where the requirements are located in the regulations, for exempt securities, the KYC and suitability process must start with the qualification of the investor to determine whether they are eligible to invest in exempt securities. If the investor does not qualify, the investment decision becomes moot and you are prohibited from offering the investment product to the client, regardless of any suitability determination.

Likewise, even where you have properly determined that a client is eligible to invest in exempt securities, this does not equate to a determination of suitability. The investment could be unsuitable for the investor if it is not appropriate for them based on a number of reasons such as their personal circumstances, financial circumstances, investment needs and objectives, investment knowledge, risk profile, or time horizon.

Exemption Qualification 2

CONTENT AREAS

Obligation to Qualify Investors for Exemption
Separate Process from KYC
Available Exemptions
Family, Friends, and Close Business Associates Exemption
Exemptions Based on Purchaser Characteristics
Reasonable Steps for Qualification
Documentary Evidence for Qualification
Breakdown of Financial Assets and Net Assets
Risk Acknowledgement
Term

INTRODUCTION

In this lesson you will learn about the obligations to qualify whether each investor is eligible to invest in exempt securities.

This unit takes approximately 35 minutes to complete.

LEARNING OBJECTIVES

At the end of this lesson, you will be able to:

1 | Discuss the obligation to qualify investors and the premise for exemption

2 | Distinguish the qualification for exemption from Know Your Client (KYC) requirements

3 | Explain the accredited investor exemption

4 | Explain the individual/spouse financial assets test

5 | Explain the individual/spouse net income test

6 | Explain the individual/spouse net worth test

7 | Explain the corporation/partnership net worth test

8 | Explain the criteria for managed accounts

9 | Explain the criteria for owners of entities who are accredited investors

10 | List other accredited investors

11 | Explain the minimum amount investment exemption

12 | Explain the offering memorandum exemption

13 | Define an eligible investor

14 | Discuss the documentary evidence for qualification

15 | Explain the guidelines in Ontario Securities Commission (OSC) Staff Notice 33-735

16 | Discuss the term of qualification

OBLIGATION TO QUALIFY INVESTORS FOR EXEMPTION

The regulations governing the exempt market require that you verify and ensure that each investor qualifies for an exemption from prospectus requirements and is therefore eligible to invest in exempt securities. These requirements are established in the securities regulations of the provincial securities regulators and the Canadian Securities Administrators (CSA) including:

- National Instrument 45-106 (NI 45-106)
- Ontario Securities Commission (OSC) Rule 45-501
- Ontario Securities Commission (OSC) Staff Notice 33-735

- Canadian Securities Administrators (CSA) Staff Notice 33-315
- Canadian Securities Administrators (CSA) Staff Notice 31-336

These instruments are designed to protect those investors who lack the sophistication or means to invest in the private market and a failure to properly qualify an investor can result in the regulators unwinding the transaction and taking serious disciplinary measures against you and your exempt market dealer (EMD).

PREMISE FOR QUALIFICATION REQUIREMENTS

The exempt market exists to provide small private issuers with a cost-effective and efficient market to raise capital. As a result, these private issuers are not subject to the requirements of the reporting issuer regime; they are less transparent; they are subject to less oversight by the regulators; and they provide less protection for investors with respect to statutory rights and disclosure. This makes exempt securities higher risk and not appropriate for most investors. Therefore, under the exempt market regime, only certain investors, namely those with more sophistication and means to withstand loss, are eligible to invest in exempt securities.

SEPARATE PROCESS FROM KYC

The process for determining whether a client qualifies to purchase an exempt product is a separate process from the Know Your Client (KYC) process. While some of the information on the KYC form (e.g. income, net worth, occupation) may be useful, KYC forms do not collect enough information to support the availability of an exemption. For example, the accredited investor exemption requires that you determine the client's "financial assets" which is different than the client's net worth. Financial assets would include investments and cash, but would not include non-financial assets and fixed assets such as real estate, automobiles, etc.

Under requirements, you are also obligated to establish an investor's eligibility at the time of each transaction. This is mandated because a client's financial circumstances could change at any given time which could disqualify them from eligibility. For this reason, NI 45-106 requires that you qualify investors for eligibility for each transaction, at the time of the transaction. This is unlike the requirements for KYC obligations which do not dictate that KYC is updated for each transaction, but rather prescribes that KYC is updated periodically and at any time you become aware of a material change in the client's circumstances.

You must be fully confident that the investor is eligible to invest in exempt securities and be confident that you can demonstrate the investor's eligibility before ever discussing the particulars of the investment with the investor.

AVAILABLE EXEMPTIONS

There are a number of exemptions in NI 41-506 which will qualify an investor to be eligible to invest in exempt securities. Some of the most common exemptions are the following:

- accredited investor (AI) exemption
- offering memorandum (OM) exemption
- family, friends, and close business associates (FFBA) exemption
- minimum amount (MA) exemption

ACCREDITED INVESTOR EXEMPTION

Under the accredited investor (AI) exemption, there are a number of different ways an investor can qualify including the following:

- Individual/Spouse Financial Assets Test
- Individual/Spouse Net Income Test
- Individual/Spouse Net Worth Test
- Corporation/Partnership Net Worth Test
- Managed Accounts
- Owners of an Entity are Accredited Investors
- Other Accredited Investors

INDIVIDUAL/SPOUSE FINANCIAL ASSETS TEST

An accredited investor under the individual/spouse financial assets test will qualify if:

- the investor, as an individual or together with a spouse, has liquid financial assets (after liabilities) of more than $1 million
- the issuer obtains a signed risk acknowledgement in prescribed form (Form 45-106F9) from the investor

The definition of financial assets is set out in the table below.

Individual/Spouse – Financial Assets	
Criteria	• the investor, as an individual or together with a spouse, has liquid financial assets (after liabilities) of more than $1 million • the issuer obtains a signed risk acknowledgement in prescribed form (Form 45-106F9) from the investor
Includes	Assets: • cash • securities • moneys owing under an insurance contract (a claim about to be paid or cash surrender value of a whole life policy) • deposit or an evidence of a deposit that is not a security • investments including RRSPs, spousal RRSPs, GICs, alternative investments, investment accounts (but not including Group RRSPs) • money held on the investors' behalf by a trustee so long as the investor has control and gets the clear benefit of the money in the trust Liabilities: • loans, lines of credit, margin, or other obligations which are used to finance investments (any investments, not necessarily the investment in question)

Individual/Spouse – Financial Assets	
Excludes	Assets: • real estate • automobiles, boats, other recreational vehicles • other fixed assets • Group RRSPs Liabilities: • mortgages, car loans, credit card debt • any other obligations not used to finance investments

INDIVIDUAL/SPOUSE NET INCOME TEST

An accredited investor under the individual/spouse net income test will qualify if the investor meets the criteria in any one of the income tests in the table below.

Individual/Spouse – Net Income Test		
Individual	• net income before taxes exceeded $200,000 in each of the 2 most recent calendar years; • reasonably expects to exceed that same net income level in the current calendar year; and • the issuer obtains a signed risk acknowledgement in prescribed form (Form 45-106F9) from the investor.	• the individual is qualified
With a Spouse	• net income before taxes exceeded $300,000 in each of the 2 most recent calendar years; • reasonably expect to exceed that same net income level in the current calendar year; and • the issuer obtains a signed risk acknowledgement in prescribed form (Form 45-106F9) from the investor.	• each spouse is qualified (even where each spouse would not qualify on their own)

INDIVIDUAL/SPOUSE NET WORTH TEST

An accredited investor under the individual/spouse net worth test will qualify if:

- the investor, as an individual or together with a spouse, has net assets (after liabilities) of at least $5 million
- the issuer obtains a signed risk acknowledgement in prescribed form (Form 45-106F9) from the investor

The definition of net worth is set out in the table below.

Individual/Spouse – Net Worth Test	
Criteria	• the investor, as an individual or together with a spouse, has net assets (after liabilities) of at least $5 million • the issuer obtains a signed risk acknowledgement in prescribed form (Form 45-106F9) from the investor
Includes	Assets: • all fixed and liquid assets • cash and investments • principal residence and other real estate Liabilities: • all debts and obligations • mortgages, loans, credit cards, etc.

CORPORATION/PARTNERSHIP NET WORTH TEST

A corporation, partnership, or other legal entity that has net assets of at least $5 million, as shown on its most recently prepared financial statements, will qualify as an accredited investor on the same basis as the individual/spouse net worth test.

MANAGED ACCOUNTS

A person acting on behalf of a fully managed account (i.e. a portfolio manager) is considered an accredited investor if that person is registered or authorized to carry on business as an adviser or the equivalent.

OWNERS OF AN ENTITY ARE ACCREDITED INVESTORS

A corporation or partnership will qualify as an accredited investor if all the beneficial owners, partners, and shareholders (except voting securities required by law to be owned by directors) qualify as accredited investors. For example, if a person has a wholly-owned (100%) holding company, the company itself may not qualify, but the owner may meet either the income or net worth test. This would allow the client to invest through the company, regardless if the company itself qualifies.

TRUSTS

A trust will qualify as an accredited investor if it is established by an accredited investor for the benefit of the accredited investor's family members where the majority of the trustees are accredited investors and the beneficiaries are the following:

- spouse, former spouse, parent, grandparent, brother, sister, child, or grandchild of the accredited investor
- parent, grandparent, brother, sister, child, or grandchild of the accredited investor's spouse or former spouse

OTHER ACCREDITED INVESTORS

Other qualified accredited investors include:

- a Canadian financial institution or bank (or subsidiary)
- the Business Development Bank of Canada (or subsidiary)
- a registered advisor (i.e. portfolio manager) or dealer or an individual registrant (or former registrant) with such a firm
- the Government of Canada, a Crown Corporation or other government agency
- a municipality, public board, or commission in Canada
- a national, federal, state, provincial, territorial, or municipal foreign government or agency
- a pension fund
- a Canadian or foreign trust company
- a Canadian registered charity that has obtained advice from an eligibility advisor or an advisor registered in the same jurisdiction as the charity
- a person (individual or legal entity) that is recognized or designated by the regulator as an accredited investor

PERMITTED CLIENTS

Permitted clients are defined in National Instrument 31-103 (NI 31-103). Generally, permitted clients are regarded as the most sophisticated and/or affluent investors in Canada including governments, banks, and investment funds. Similar to the criteria which qualify accredited investors, permitted clients qualify for exemption and are eligible to invest in exempt securities.

OFFERING MEMORANDUM EXEMPTION

Investors will qualify to invest in exempt securities under the offering memorandum (OM) exemption where the issuer provides the investor with an *Offering Memorandum* in prescribed form and obtains a signed risk acknowledgement in prescribed form (Form 45-106F4/45-106F5) from the investor. As shown in the table below, the offering memorandum exemption varies depending on the jurisdiction.

Offering Memorandum Exemption		
Jurisdiction	**OM Exemption**	**Other Conditions**

Ontario
Alberta
New Brunswick
Nova Scotia
Quebec
Saskatchewan
	The exemption is available when:
	• the client buys the security on his or her own behalf; and
	• at, or prior to, the time when the purchaser signs the purchase agreement, the issuer:
	  ◦ delivers an *Offering Memorandum* in prescribed form to the purchaser, and
	  ◦ obtains a signed risk acknowledgement in prescribed form (Form 45-106F4/45-106F5) from the purchaser which includes:
	    Schedule 1: Classification of Investors Under the Offering Memorandum Exemption
	    Schedule 2: Investment Limits for Investors Under the Offering Memorandum Exemption
		• ceiling of $10,000 can be invested under the OM exemption in a 12-month period if the purchaser is an individual and is not an "eligible investor"
		• ceiling of $30,000 can be invested under the OM exemption in a 12-month period if the purchaser is an individual qualified as an "eligible investor", but has not received advice from a portfolio manager, investment dealer, or exempt market dealer that the investment is suitable
		• ceiling of $100,000 can be invested under the OM exemption in a 12-month period if the purchaser is an individual qualified as an "eligible investor" and has received advice from a portfolio manager, investment dealer, or exempt market dealer that the investment is suitable
		• the risk acknowledgement obtained by the investor must include the additional Schedules 1 and 2
		• all marketing materials for the offering must be referenced in a statement within the OM
		• restrictions on securities that can be distributed under the OM exemption are:
		  ◦ specified derivatives
		  ◦ structured finance products
		  ◦ investment funds[1]
		• issuers must file *Audited Annual Financial Statements* and *Notice of Use of Proceeds* with the securities regulators

[1] Investment funds are restricted in Alberta, Nova Scotia, and Saskatchewan unless they are non-redeemable investment funds or mutual funds that are reporting issuers. All types of investment funds are restricted in Ontario, New Brunswick, and Quebec.

Offering Memorandum Exemption		
Jurisdiction	**OM Exemption**	**Other Conditions**

British Columbia
Newfoundland and Labrador
Manitoba
Northwest Territories
Nunavut
Prince Edward Island
Yukon
	The exemption is available when:
	• the client buys the security on his or her own behalf; and
	• at, or prior to, the time when the purchaser signs the purchase agreement, the issuer:
	  ◦ delivers an *Offering Memorandum* in prescribed form to the purchaser, and
	  ◦ obtains a signed risk acknowledgement in prescribed form (Form 45-106F4/45-106F5)from the purchaser.
		• no ceiling on the amount of the purchase
		• no terms specifically relating to restrictions on securities distributed or investment funds
		• no conditions on marketing materials
		• no continuous reporting requirements

An “eligible investor” under the offering memorandum (OM) exemption includes, among others, those investors who meet the criteria in the table below.

Eligible Investor	
Eligible investors who meet the net worth or income tests	• net assets, alone or with a spouse, in the case of an individual, exceed $400,000* • net income before taxes exceeded $75,000 in each of the 2 most recent calendar years and who reasonably expects to exceed that income level in the current calendar year, or • net income before taxes, alone or with a spouse, in the case of an individual, exceeded $125,000 in each of the two most recent calendar years and who reasonably expects to exceed that income level in the current calendar year (* includes the value of real property, less any mortgages or other liabilities against the property, and must include income taxes owed as a liability)
Other eligible investors under the OM exemption	• a corporation where a majority of the voting securities are owned by eligible investors or a majority of the directors are eligible investors • a general partnership where all the partners are eligible investors • a limited partnership where the majority of the general partners are eligible investors • a trust or estate where all of the beneficiaries or a majority of the trustees or executors are eligible investors • an accredited investor • family, friends, and business associates (as defined in NI 45-106) • in Manitoba, Northwest Territories, Nunavut, Prince Edward Island and Yukon, a person who has obtained advice regarding the suitability of the investment from an eligibility adviser** *(** A person registered as an investment dealer except those operating under an exemption from suitability requirements. In Saskatchewan and Manitoba, includes certain lawyers and public accountants.)*

The investment limits for non-eligible and eligible investors under the OM exemption apply to individuals. As such, the investment limits do not apply to corporations, partnerships, trusts, unincorporated syndicates, and unincorporated organizations. However, relief from the investment limits is strictly intended for such entities that have been established for *bona fide* purposes and not for those who form such entities to avoid the OM exemption investment limits. You should expect close scrutiny on this from internal compliance and in compliance reviews conducted by the securities regulators.

FAMILY, FRIENDS, AND CLOSE BUSINESS ASSOCIATES EXEMPTION

Investors will qualify to invest in exempt securities under the family, friends, and close business associates (FFBA) exemption where the investor has a relationship with the issuer including:

- directors, executive officers, control persons, and founders of the issuer
- family members, close personal friends, and close business associates of directors, executive officers, control persons, or founders of the issuer including a:
  - spouse
  - parent
  - grandparent
  - brother
  - sister
  - child
  - grandchild
  - close personal friend
  - close business associate

The onus is on the issuer to establish whether a close personal relationship exists and the issuer must obtain a signed risk acknowledgement in prescribed form from the purchaser (Form 45-106F12). The risk acknowledgement must be obtained before or at the time the exempt security is purchased.

MINIMUM AMOUNT EXEMPTION

The minimum amount (MA) exemption is also commonly known as the "$150,000 exemption". An investor will qualify under the minimum amount exemption if the following conditions are satisfied:

- the investor is NOT an individual
- the investor buys the securities as principal
- the securities have an acquisition cost to the investor of not less than $150,000, paid in full at the time of the trade
- the trade is in respect of a security of a single issuer

This exemption does not apply if the investor is a company created or used solely to purchase or hold securities in reliance on this exemption.

The MA exemption is the only exemption which does not require subsequent qualification, where the investor makes a secondary purchase in the security of the same single issuer.

EXAMPLE

Investrite Inc. initially purchased $150,000 worth of shares of Aliki & Co. under the minimum amount investment exemption. They subsequently purchased units of the same security. Investrite Inc. need not re-qualify as they will still be considered to be purchasing under that exemption regardless of the amount they subsequently buy.

EXEMPTIONS BASED ON PURCHASER CHARACTERISTICS

Where investors qualify to invest in exempt securities based on the characteristics of the purchaser, you are required to take reasonable steps, as defined in the companion policy NI 45-106CP, to qualify the investor for exemption.

Exemptions Based on Purchaser Characteristics

Exemption	Purchaser Characteristics
Accredited investor (AI) exemption	Exemption based on income or asset tests
Eligible investor under the offering memorandum (OM) exemption	
Family, friends, and close business associates (FFBA) exemption	Exemption based on relationships
Private issuer exemption	

REASONABLE STEPS FOR QUALIFICATION

You are required to take reasonable steps to qualify an investor for exemption. Summarized in the table below are the steps for qualification established in OSC Staff Notice 33-735 and companion policy NI 41-506CP.

Steps for Qualification

Understand the terms and conditions	• explain the terms and conditions of the exemption to the purchaser • apply the specific facts about the purchaser to the terms and conditions of the exemption
Verification	• verify that the purchaser qualifies for exemption • obtain information that confirms that the purchaser is eligible for exemption ***Exemptions based on income or asset tests:*** • ask questions about the purchaser's financial circumstances which will elicit details about their net income, financial assets, and net assets • where concerns about eligibility arise, ask to see documentation that independently confirms income, assets, etc.

Steps for Qualification	
	Exemptions based on relationship: • ask the purchaser questions to elicit details about the nature and length of the relationship between the purchaser and the principal of the issuer • confirm details about the nature and length of the relationship with the principal of the issuer for accuracy ***Insufficient Qualification*** It is considered insufficient to rely solely on a client's initialling or checking off a box on a subscription/certificate which merely confirms that the purchaser is an accredited investor, a family member, etc.
Documentation	• retain documents to evidence the steps taken to verify the purchaser's eligibility for the exemption • consider whether it is necessary to have the purchaser sign the documents before distributing securities to the purchaser • obtain a signed risk acknowledgement form where required for the exemption • information contained in the client's completed KYC form and other documents (e.g. the notes of the Dealing Representative) must demonstrate that the client qualifies for exemption
Do not sell exempt securities to ineligible investors	• where sufficient information to qualify the purchaser is not available

DOCUMENTARY EVIDENCE FOR QUALIFICATION

You are required to retain documents to evidence that you properly qualified an investor for exemption. While it is not prescribed that you obtain statements, proof of assets, pay statements, or tax receipts to substantiate an investor's income, financial assets, net worth, etc., you are expected to have documentary evidence to support that you made appropriate inquiries (e.g. calculations to support financial assets, net worth) and you have a reasonable basis for believing that the investor qualifies for exemption.

In Ontario Securities Commission (OSC) Staff Notice 33-735, the OSC states:

> *"We will take enforcement proceedings or other regulatory action where issuers and dealers are acting contrary to securities law by selling exempt securities under the AI exemption to investors who are not Accredited Investors."*

In *Sawh and Trkulja* (*Re Sawh and Trkulja* (2012), 35 O.S.C.B. 7431, at 7454, para. 183, *affirmed* 2013 ONSC 4018 (Div. Ct.)), the Ontario Securities Commission said:

> *"The fact that an investor declared himself to be an accredited investor does not absolve a registrant of the responsibility to take adequate steps in the circumstances to ascertain that the investor meets the criteria to be accredited based on his or her financial circumstances."*

BREAKDOWN OF FINANCIAL ASSETS AND NET ASSETS

In Companion Policy (CP) 31-103, s. 13.2 and CSA Staff Notice 31-336, the regulators have provided guidance with respect to the supporting documents that should be retained to support the qualification of an investor for exemption. Where the client purchases exempt securities under the accredited investor exemption or as an eligible investor under the offering memorandum exemption, you are expected to obtain a:

- Breakdown of financial assets and net assets of the client

The purpose of the *breakdown of financial assets and net assets* is to ensure that information is collected to accurately reflect the client's financial circumstances and to assist you in assessing the availability of the prospectus exemptions.

RISK ACKNOWLEDGEMENT

For exempt securities offered to investors under the accredited investor (AI), offering memorandum (OM), and family, friends, and close business associates (FFBA) exemptions, the issuer is required to obtain a signed risk acknowledgement in prescribed form from the purchaser before or at the time the exempt security is purchased.

The *Risk Acknowledgement Form* contains a summary, by the securities commissions, of exempt securities and the risks of investing in them.

Risk Acknowledgement

Exemption	Risk Acknowledgement
Accredited investor (AI)	Form 45-106F9
Offering memorandum (OM)	Form 45-106F4 (For 45-106F5 Saskatchewan)
Family, friends and close business associates (FFBA)	Form 45-106F12

The risk acknowledgement form prescribed in the following provinces also includes Schedules 1 and 2 concerning investor classifications and investment limits:

<table>
<tr><th colspan="3">Schedules 1 and 2</th></tr>
<tr><th>Province</th><th>Schedule</th><th>Details</th></tr>
<tr><td rowspan="2">Ontario
Alberta
New Brunswick
Nova Scotia
Quebec
Saskatchewan</td><td>Schedule 1:
Classification of Investors Under the Offering Memorandum Exemption</td><td>• requires the investor to confirm their status as an eligible investor, non-eligible investor, accredited investor, or an investor who qualifies under the FFBA exemption</td></tr>
<tr><td>Schedule 2:
Investment Limits for Investors Under the Offering Memorandum Exemption</td><td>• requires the investor to confirm that they have invested within the prescribed limits</td></tr>
</table>

TERM

Once an investor qualifies as an accredited investor under the accredited investor exemption or as an eligible investor under the offering memorandum exemption, it is not necessary that they continue to qualify after the subscription of the exempt securities has been completed. If the client's circumstances change so that they become disqualified after the transaction, they are still eligible to continue holding the securities. No action is required and the exempt securities can be held until liquidation.

The qualification of the investor must be completed for each transaction, at the time of the transaction. Where a client's circumstances change so that they become disqualified after a transaction, they will no longer be eligible for new transactions in exempt securities.

Know Your Client 3

CONTENT AREAS

- Know Your Client
- New Client Application Form (NCAF)
- KYC Consistency with Qualification Documents
- KYC Confirmation
- Keeping KYC Current

INTRODUCTION

In this lesson you will learn about the Know Your Client (KYC) obligation.

This unit takes approximately 45 minutes to complete.

LEARNING OBJECTIVES

At the end of this lesson, you will be able to:

1 | Discuss the Know Your Client (KYC) obligation

2 | Discuss completion of the New Client Application Form (NCAF)/Know Your Client (KYC) Form

3 | Explain identification requirements

4 | Explain personal circumstances

5 | Explain financial circumstances

6 | Explain investment needs and objectives

7 | Explain investment knowledge

8 | Explain risk profile

9 | Explain time horizon

10 | Discuss KYC consistency with qualification documents

11 | Explain KYC confirmation

12 | Discuss keeping KYC current

KNOW YOUR CLIENT

The Know Your Client (KYC) rule is the single most important rule to those industry participants who provide investment advice to investors. The KYC requirement establishes the diligence to be exercised when offering investment products and advice to clients. The objective of the KYC obligation is to ensure that the essential facts about an investor are known so that the information can form a basis for determining whether investment recommendations will be suitable for them. This helps protect investors, registrants, and the integrity of the capital markets.

Under the KYC obligation, it is your responsibility to collect and consider essential information about your clients to ensure that they are well served by investments that suit their individual financial needs. In Canada, the Know Your Client requirements are established in:

- National Instrument 31-103 (NI 31-103), s. 13.2, Know Your Client
- the rules of the Self-Regulatory Organizations (SROs)

Further interpretation and guidance is provided in:

- Companion Policy (CP) 31-103, s. 13.2, Know Your Client
- Canadian Securities Administrators (CSA) Staff Notice 33-315
- Canadian Securities Administrators (CSA) Staff Notice 31-336

NI 31-103, s. 13.2 establishes that, to meet your suitability obligation, you must take reasonable steps to:

- establish the identity of the client
- collect and consider sufficient information about the client's:
  - personal circumstances
  - financial circumstances
  - investment needs and objectives
  - investment knowledge
  - risk profile
  - time horizon

The KYC, KYP, and suitability obligations are the most fundamental and important duties of every Dealing Representative. Knowing your client is not merely checking boxes on a form; it involves having meaningful conversations with your clients that allow you to truly know and understand their means, needs, limitations, circumstances, finances, and investment goals. Otherwise, you will not be able to make suitable recommendations or provide adequate service to your clients.

The KYC obligation cannot be delegated, for example to a third party such as a referral agent.

Under regulatory requirements, you are expected to:

- have a meaningful interaction with the client during your KYC process
- discuss with the client their role in keeping KYC information current
- tailor the KYC process to reflect the nature of the relationship with the client
  - For example, the regulators expect that extensive KYC information will be required if you are offering an ongoing and fully customized service or an investment product or strategy that is illiquid or highly risky.

The regulators expect you to help your clients understand KYC terminology, inquire about any noted KYC responses which appear inconsistent, and provide assistance to help clients define their investment needs and objectives. You are expected to be particularly conscientious in your KYC discussions with vulnerable or unsophisticated clients.

Further, Companion Policy (CP) 31-103, s. 13.2 establishes that the regulators expect EMDs to develop a KYC process that collects sufficient information about clients to allow the EMD to determine whether clients qualify to invest in exempt securities under a prospectus exemption. The regulators give further guidance in the CSA's *Client Focused Reforms Frequently Asked Questions*.

"Client's Interest First" Standard

As set out in the *Client Focused Reforms Frequently Asked Questions, s.2*.:

> *"There are circumstances where a registrant may need to enquire about investments the client holds outside of the registrant to have a better understanding of a client's financial circumstances to sufficiently support its suitability determination (this is the case currently as well as under the CFRs). This information may be particularly important to a registrant's ability to assess whether an investment might lead a client to become over-concentrated in a security or sector or whether the client qualifies for a prospectus exemption.*
>
> *For example, we currently expect dealers to obtain a breakdown of financial assets and net assets of the client to ensure that the information collected accurately reflects the client's financial circumstances and to assist the registrant in assessing the availability of the prospectus exemptions and the suitability of any investment made. We also expect dealers to make further inquiries about the client's financial circumstances in situations where there is a reasonable doubt about the accuracy of information given by the client or the validity of the client's claim to be an accredited investor or eligible investor."*

The KYC requirement is an ongoing obligation. It does not end after the initial KYC is recorded and considered when the new account is opened. You are responsible for periodically reviewing and updating the KYC information on file for your clients.

The most common source of regulatory enforcement proceedings and civil legal actions against Dealing Representatives and EMDs stem from claims that the Dealing Representative failed to know the client and failed to make suitable investment recommendations.

NEW CLIENT APPLICATION FORM (NCAF)

The KYC process starts with the *New Client Application Form* (NCAF), also referred to as the Know Your Client (KYC) Form, which must be completed for each new client account that is opened. Complete KYC information must be collected and considered when accounts are opened and before trades and subscriptions are executed.

In cases of disputes, the KYC Form will customarily be reviewed by regulators and lawyers to ascertain whether you knew the client and recommended suitable investments. However, investigation into suitability disputes will go beyond the information that is collected on the KYC Form, specifically if the information on the form appears unreasonable given the client's circumstances.

In order to collect the necessary KYC information, most NCAF/KYC Forms include the following sections:

- identification
- personal circumstances
- financial circumstances
- investment needs and objectives
- investment knowledge
- risk profile
- time horizon
- asset allocation (the % of exempt securities as part of the client's portfolio)

The NCAF/KYC Form should be completed, signed, dated, and then reviewed by the EMD. The client should receive a signed copy of the NCAF/KYC Form for their records.

IDENTIFICATION

Under the KYC obligation, you have a duty to establish the identity of each client. Where there is any cause for concern, you are required to make reasonable inquiries as to the reputation of the client. Under Companion Policy (CP) 31-103, s. 13.2, the regulators establish their expectations of EMDs and Dealing Representatives in their role as "gatekeepers" to the capital market. As part of their gatekeeper role, EMDs and Dealing Representatives:

- are required to establish the identity of, and conduct due diligence on, their clients
- should not, by act or omission, facilitate conduct that brings the market into disrepute

These obligations to establish and confirm a client's identity are synonymous with the legislation under the Proceeds of Crime (Money Laundering) and Terrorist Financing Act (PCMLTFA).

PERSONAL CIRCUMSTANCES

The obligation to learn the essential facts about each client includes learning about their personal circumstances. A client's personal circumstances have an impact on their investment needs and include those elements below.

Personal Circumstances

- age, date of birth
- address and contact information
- civil status/family situation (e.g. marital status)
- number of dependents
- other persons who are authorized to provide instructions on the account
- other persons who have a financial interest in the account

For clients who are not individuals, the KYC information below must be collected and replaces the Personal Circumstances section above for individual clients.

KYC for Clients who are not Individuals

- legal name
- head office address and contact information
- type of legal entity (i.e. corporation, trust, etc.)
- form and details regarding the organization of the legal entity (i.e. articles of incorporation, trust deed, other constating documents)
- nature of business
- persons authorized to provide instructions on the account
- details of any restrictions on the authority of the persons authorized
- other parties who have a financial interest in the account

AGE

The age of a client is one of the essential criteria to be considered when assessing investment suitability. Age is important for several reasons:

- There is a legal age of majority in each province. Agreements, including the purchase of securities, entered into by people who are not of legal age may not be enforceable.
- There are age restrictions for certain accounts, such as Registered Education Savings Plans (RESPs) and Registered Retirement Savings Plans (RRSPs).
- The client's age ties in closely with short, medium, and long-term financial goals.

For instance, a 25-year-old man with 40 years until retirement will likely have different investment needs and objectives and risk profile than a man of 60 who is approaching retirement.

FINANCIAL CIRCUMSTANCES

The client's financial circumstances are a key component of the client's KYC information and includes those elements below.

Financial Circumstances
• employment status and occupation • annual income • net worth • financial assets and liquid assets • liquidity needs • whether the client is using leverage or is borrowing to invest • creditworthiness

OCCUPATION AND EMPLOYMENT STATUS

Occupation and employment status are important factors when assessing suitability. For example, clients who are retired and living on a fixed income will have different objectives than those in their high-income earning years. In addition, some clients may have cyclical jobs or may be paid by commission. In these cases, their income may vary dramatically from year to year. It is important to recognize the potential gaps in clients' income and work with them to meet both short-term liquidity needs and longer-term investment requirements. Occupation may have an impact on whether there is a reasonable expectation that the client is an eligible investor, accredited investor, or permitted client.

INCOME

Annual income is critical to assessing an individual's financial condition and can be an indicator of whether they can withstand volatility or loss. Generally, clients with a low income are expected to have a lower risk profile, a higher need to preserve their principal, and increased liquidity requirements because significant life events (losing a job, buying a house, etc.) may result in the need to depend on their investments.

For example, if the client will depend on the income generated by their investments to live on, then their financial circumstances would likely not allow for exposure to the exempt market. It would also not be generally suitable for a client with a low income to be invested through a leveraging strategy. On the other hand, a client earning $100,000 from employment with a healthy net worth would likely be less affected by a loss.

Asking the following questions can help determine the client's income:

- What is your income and cash flow?
- What are your sources of income?
- Is your level of income consistent or does it vary?

Income is commonly recorded in ranges on the KYC Form as illustrated below.

Income
• <$75K • $75,001 - $100K • $100,001 - $199,999 • $200K - $300K • >$300K

From the perspective of income, the higher the income, the more likely the client will be suited for investment in the exempt market, assuming they are eligible to do so. Conversely, lower income would indicate that the client may not be suited for investment in these higher risk products.

NET WORTH

Net worth, along with other KYC factors including investment needs and objectives, income, and risk profile, is an important factor when considering whether an exempt security is appropriate for a client. Net worth should be calculated as the estimated liquid assets plus fixed assets less estimated liabilities. Net worth should only include assets of the client and his or her spouse.

Asking the following questions can help determine the client's net worth:

- What is your net worth?
- What are your fixed assets (e.g. residence, real estate)?
- What are your liquid assets (e.g. cash, investments)?
- What are your liabilities (e.g. mortgages, loans, credit cards)?
- What are your outstanding tax obligations (e.g. taxes due)?

Net worth is commonly recorded in ranges on the KYC Form as illustrated below.

Net Worth
• <$50K • $50,001 - $100K • $100,001 - $200K • $200,001 - $500K • $500,001 - $1M • >$1M

The regulators expect you to take reasonable steps to obtain a breakdown of financial assets, including capturing information about the client's investments held outside of the EMD, in order to assess over-concentration.

For leveraged accounts, you must record the details of the net worth calculations, specifying:

- **liquid assets:** cash, investments
- **fixed assets:** residence, real estate
- **liabilities:** debts, mortgages, loans, credit cards

From the perspective of net worth, the higher the net worth, the more likely the client will be suited for investment in the exempt market, assuming they are eligible to do so. Conversely, lower net worth would indicate that the client may be suited for little or no investment in these higher risk products.

LIQUIDITY

Liquidity needs are an important aspect of a client's financial circumstances. Ascertaining a client's liquidity needs includes determining:

- the extent to which a client wishes or needs to access all or a portion of their investments to meet their ongoing and short-term expenses
- financial obligations or major planned expenditures

- whether the client has any other means to cover their expenditures
- the frequency of any required withdrawals

Extra caution should be exercised when dealing with clients who have a high need for liquidity given that highly liquid investment products are generally not available in the exempt market.

LEVERAGE

You are required to determine whether a client will use leverage or borrow to invest and collect and compute additional information about their financial circumstances in order to determine whether leverage will be suitable including:

- net worth
- liquid net worth
- capacity (e.g. total debt service ratio (TDSR) and percentage of net worth (%NW))

The purpose of collecting this additional financial criteria is to assess the client's ability to meet debt obligations and to assess whether leveraged investing will be suitable for the client.

INVESTMENT NEEDS AND OBJECTIVES

The investment needs and objectives and risk profile of a client are the most critical criteria in assessing whether an investment product or investment strategy is suitable for a client. The client's investment needs and objectives define the ultimate goal that the client has for the invested capital and the result they aspire to achieve with the investment.

Investment needs and objectives are often categorized as follows:

Investment Needs and Objectives	
Safety	Where a client's objective is safety, their goal is to preserve their capital and minimize volatility and the risk of losing money. The client should be willing to accept lower returns in order to reduce risk.
Income	Where a client's objective is income, their goal is to generate income from their investments and capital appreciation is not the primary requirement.
Growth	Where a client's objective is growth, their goal is capital appreciation and income from their investments is not a primary requirement. The client would generally have a medium to high risk profile.
Speculation	Where a client's objective is speculation, generally their goal is to generate higher returns from higher risk investments which generally have higher volatility.

Clients can have multiple needs and objectives, for example, income and growth. In such cases, you are expected to help your clients define the relative importance of each objective. Most EMDs accommodate this by offering a KYC Form that allows the investment needs and objectives to be recorded in percentages.

As set out in CP 31-103, s. 13.2, when determining a client's investment needs and objectives, the regulators expect you to provide clients with the opportunity to express their investment needs and objectives in non-technical terms that are meaningful to them, for example:

- save for retirement
- increase wealth by a certain percentage in a specific number of years

- invest for the purchase of a home
- invest for the post-secondary education of children

The CP goes on to state:

> *"Depending on the nature of the relationship with the client, and the securities and services offered by the registrant, it may be appropriate to set out investment goals for a client's account or portfolio which may be done by developing an investment policy statement. Where investment goals are agreed upon with a client, they should be set out in terms that are specific and measurable. A registrant should consider setting out investment return assumptions that would be required to meet the client's investment needs and objectives. A registrant should also periodically update the client on progress towards any goals set for their account or portfolio."*

To determine your client's investment needs and objectives, you may want to ask questions such as those below.

- What are your financial goals?
- Do you have more than one goal?
- When do you want to achieve these goals?
- Are your goals realistic?
- Do you foresee any limitations in achieving those goals?
- What are your income needs?

Answers to some of these questions might include:

- plan for retirement
- use a portion of my worth to achieve higher returns and build more value over time
- provide income in retirement but use only what is needed in order to leave money for my children
- give to charities toward the end of my life
- save to buy a house in 5 years

Whatever the answers, they will surely help when deciding what approach to use and what products to recommend. When determining suitability, you must compare the investment needs and objectives of the client and the features of the investment product or investment strategy to assess whether they align with each other.

EXAMPLE

Shane and Annabelle, a married couple in their mid-60s, are drawing a retirement income. Their priorities are to preserve capital and generate a regular income. Exempt securities are not geared towards capital preservation. On the other hand, their son Elliot is more inclined to invest for longer-term growth to build a pool of wealth for future financial needs.

From the perspective of exempt securities, the more the client's investment needs and objectives are focused towards growth and speculation, the more likely they will be suited for investment in the exempt market, assuming they are eligible to do so. Conversely, investment needs objectives focused towards safety and preserving capital would indicate that the client may not be suited for investment in these higher risk products. For example, an exempt product in land development with a time horizon of 7 years or more would not be appropriate for a client saving to buy a house in 5 years or for a client seeking income and liquidity from the investment.

INVESTMENT KNOWLEDGE

Investment knowledge reflects the client's comprehension about investments and investing including their understanding about the:

- financial markets
- the relative risks and limitations of various types of investments, and how the level of risk taken affects potential returns

You are expected to learn about your client's level of awareness and previous experiences with finances and investments. Specifically, you should be alert where investment knowledge flags inconsistencies with other KYC criteria, for example where a client indicates that they have limited investment knowledge and experience, but also indicate that they have a high-risk profile.

Investment experience reflects how much investing the client has done previously and the nature and complexity of those investments. Investment experience is not the same as investment knowledge. You cannot assume that because a client has previous investment experience that they have investment knowledge. Some clients may know a great deal about investing and various types of investments without ever having made investments. Other clients may know very little, despite having numerous previous investments.

Investment experience is usually recorded on the KYC Form in a section where the client's previous investments can be listed or checked off using tick boxes. Investment knowledge is commonly recorded by selecting from a list of options on the KYC Form as illustrated below.

Investment Knowledge	
Definition	The client's knowledge about investments and investing
Options	• Novice (Low) • Fair (Average) • Good (Above Average) • Sophisticated (High)

Becoming familiar with your client's level of investment knowledge helps you to determine the types of investments you might recommend. Investment knowledge is a particularly important factor to consider when determining whether higher risk investment products such as exempt securities are appropriate for a client. The more complex or the higher the risk of the investment, the more sophisticated the client should be.

RISK PROFILE

When determining the suitability of an investment product or investment strategy for a client, perhaps the most important factor is the client's risk profile. Along with investment needs and objectives, risk profile is the most important key component of the client's KYC.

Establishing a client's risk profile involves the determination of two (2) criteria:

1. The client's risk tolerance: the client's willingness to accept risk
2. The client's risk capacity: the client's ability to endure potential financial loss

Risk tolerance and risk capacity are separate considerations that together make up the client's overall risk profile. The client's risk profile should reflect:

- the lower of: (1) the client's risk tolerance and (2) the client's risk capacity

Assessing a client's risk capacity requires you to have an understanding about the client's personal and financial circumstances, investment needs and objectives, and other KYC criteria that would impact their ability to sustain investment losses. When assessing a client's risk capacity, you should consider the client's:

- liquidity needs
- debts
- income
- assets
- the weighting of the client's investment(s) in relation to their overall financial position
- age
- life stage

It is also important that you do not confuse risk profile with other KYC criteria such as income, net worth, and time horizon. While you should consider these criteria and discuss them with your clients to assist them in understanding risk and return, the criteria should not override the client's final assessment of their actual willingness and ability to accept risk. Consider, for example, a client who may be very affluent but loses sleep when his publicly listed stocks are volatile causing him to panic and sell at the wrong time.

The regulators expect you to document the questions and answers you use to establish your clients' risk profiles. Assessing a client's risk profile is sometimes determined by using tools such as questionnaires. You should be fully aware of the questionnaires approved by your EMD and the firm's policies and procedures for determining risk profile.

EMDs are expected to have definitions related to risk profile. The definitions for risk profiles will be established in the EMD's policies and procedures and Relationship Disclosure Information (RDI).

Generally, the summary in the table below is true.

Risk Profile	
Low	• means you cannot lose any part of your investment
Medium	• means you can risk losing part of your investment
High	• means you can risk losing your total investment

It is important to note that exempt securities are unique in their lack of transparency and pricing information which creates the impression that the investments are not volatile. It is important not to equate this lack of visible volatility with lower risk. Private placement investments can sometimes result in a total loss of the client's investment without warning. It is therefore important to ask yourself if the client would be able to withstand such an event.

With respect to real-estate based investments such as real estate investment trusts (REITs), mortgage investment corporations (MICs), and land development limited partnership units (LPUs), the Canadian Securities Administrators (CSA) has indicated that EMDs and Dealing Representatives are expected to discuss the potential risks associated with these products. If you offer these exempt products, you are expected to discuss the risks inherent in these products such as the potential impact from a possible downturn in the real estate market or increased mortgage defaults by sub-prime borrowers.

Like investment needs and objectives, risk profiles are often expressed in percentages which are recorded on the client's KYC Form/NAAF. From the perspective of exempt securities, the higher the risk profile, the more likely the client will be suited for investment in the exempt market, assuming they are eligible to do so. Conversely, a lower risk profile would indicate that the client may be suited for little or no investment in these higher risk products.

Errors in correctly assessing a client's risk profile can result in significant ramifications including client complaints, enforcement proceedings, and legal action. It is therefore important that you do not substitute your own judgment for that of your client when it comes to risk profile. If the client is not comfortable with a certain level of risk, the KYC should reflect that decision.

RISK VERSUS RETURN CONFLICTS

You should be aware that, in some cases, there will be a mismatch between the risk a client is willing or able to accept and the return the client expects. Higher expected returns come with inherently higher risk. Under these circumstances, you may be tempted to assess a higher risk profile than you should in an attempt to meet the client's return expectations. Resist this temptation.

Where a client's desire for returns does not align with their risk profile, you are expected to follow prescribed steps to protect the client from assuming too much risk, as set out in CP 31-103, s. 13.2.

Resolving conflicts between a client's expectations and risk profile

As set out in CP 31-103, s. 13.2:

> *"Registrants should not override the risk a client is willing and able to accept on the basis that the client's expectations for returns cannot otherwise be met given the risk profile associated with their KYC responses. The registrant should identify any mismatches between the client's investment needs and objectives, risk tolerance and capacity for loss. The questions at the source of this conflict should be revisited with the client. If a client's goals or return objectives cannot be achieved without taking greater risk than they are able or willing to accept, alternatives should be clearly explained such as saving more, spending less or retiring later.*
>
> *Where after discussion, it is determined that the client does not have the capacity or tolerance to sustain the potential losses and volatility associated with a higher risk portfolio, the registrant should explain to the client that their need or expectation for a higher return cannot realistically be met, and as a result, the higher risk portfolio is unsuitable. The interaction with the client and end results should be properly documented."*

TIME HORIZON

Time horizon refers to the length of time the client will hold the investment before they will need to liquidate it and access the funds. Time horizon can range from short to long periods and will depend on the investor's individual objectives.

Time horizon is customarily recorded in ranges on the KYC Form similar to the ranges in the table below.

Time Horizon	
Definition	The time from the purchase to the time when the client will need to access a significant portion of the money invested
Options	< 1 Year (Short-Term) 1 - 3 Years (Short-Term to Medium) 3 - 5 Years (Medium) 5<10 Years (Long) 10<20 Years (Very Long) 20+ Years (Very Long)

A client's time horizon should be feasible and reasonable give the client's liquidity needs, age, investment needs and objectives, risk profile, and other KYC criteria. From the perspective of exempt securities, the longer the time horizon, the more likely the client will be suited for investment in the exempt market, assuming they are eligible to do so. Conversely, shorter time horizons would indicate that the client may not be suited for investment in these less liquid products.

KYC CONSISTENCY WITH QUALIFICATION DOCUMENTS

Where the client purchases exempt securities under the accredited investor exemption or as an eligible investor under the offering memorandum exemption, the documents supporting qualification of the client's eligibility must be consistent with the KYC documents. There should not be any discrepancies between the KYC Form and the eligibility documents (e.g. AI Certificate, Schedule 2 of the Risk Acknowledgement, etc.), and the documents should be reasonable given the client's circumstances.

KYC CONFIRMATION

Registered firms and individuals are required to take reasonable steps to have their clients confirm that their KYC information is correct. As such, you are required to follow your EMD's policies and procedures with respect to:

- obtaining confirmation from clients of the accuracy of KYC information collected
- documenting clients' confirmation of KYC
- providing written confirmation to the client of KYC information updated/confirmed
- providing the opportunity for clients to correct their KYC information

KEEPING KYC CURRENT

KYC information forms the basis for determining whether trades in securities and other investment actions are suitable for investors. As such, you are required to make reasonable efforts to keep KYC information current. KYC must be reviewed with clients and, where necessary, updated no less than:

- when there is a material change in the client's circumstances and/or KYC criteria
- within the previous 12 months before a trade or recommendation

The regulators expect you to make reasonable enquiries to determine if there has been a significant change to a client's KYC information.

Material changes include changes to:

- marital status
- financial status including employment, income, and net worth
- all changes to KYC information including risk profile, investment needs and objectives, and time horizon

Know Your Product 4

CONTENT AREAS

INTRODUCTION

In this lesson you will learn about the Know Your Product (KYP) obligations.

This unit takes approximately 15 minutes to complete.

LEARNING OBJECTIVES

At the end of this lesson, you will be able to:

1 | Provide an overview of the Know Your Product (KYP) obligation

2 | Explain the obligations of the exempt market dealer (EMD) for product due diligence

3 | Explain product due diligence and the factors considered in the analysis of an investment product or investment strategy

4 | Explain your restrictions and responsibilities as a Dealing Representative

5 | Explain the KYP obligations concerning the risks of exempt securities

KNOW YOUR PRODUCT

The Know Your Product (KYP) requirement is an integral part of the overall suitability assessment. It is important because you cannot align suitable investments to a client's investment needs and objectives unless you fully understand the features of the product. Under the KYP obligation, you are required to learn the essential facts about each investment product and investment strategy in order to fulfill your suitability obligation. In doing so, you are required to take reasonable steps to learn the essential facts about each investment product and investment strategy that will be offered to or held for your clients.

Although the KYP obligation is triggered when you recommend an investment product to a client or take any other investment action, you and your EMD may be deemed to implicitly recommend a product by merely having the product on your shelf or by advertising and promoting the product. The KYP obligation extends to all proprietary products of the firm and those of any related and connected issuers.

THE FIRM'S PRODUCT DUE DILIGENCE

The KYP obligation requires the EMD to review and approve all investment products and investment strategies before the firm or its Dealing Representatives make them available to clients. In doing so, the EMD is required to take reasonable steps to understand the investments' structure, features, risks, initial and ongoing costs, and the impact of those costs. EMDs are further required to monitor approved investment products and strategies for significant changes and update their product records accordingly.

The interpretation and guidance policies of the securities regulators convey their expectations of registered firms, including EMDs, under their KYP obligation. Summarized below are the factors that have been identified as those that should be considered in a registered firm's product due diligence analysis.

Product Due Diligence Analysis	

Product	• risks
	• investment mandate/objectives
	• structure and features
	• complexity
	• transparency
	• basis/source of projected returns
	• assessment of the likelihood that the projected returns will be delivered
	• use of leverage
	• duration, maturity date, time horizon
	• redemption features
	• secondary market (yes/no)
	• liquidity, liquidity restrictions
	• nature of the underlying investment products and strategies (where applicable, for example for structured products)
	• tax treatment
	• novel features
	• initial and ongoing costs of acquiring, owning, and disposing of the investment product including:
	  ◦ fees
	  ◦ commissions
	  ◦ sales charges
	  ◦ trailer fees
	  ◦ management fees
	  ◦ incentive fees
	  ◦ referral fees
	  ◦ redemption fees
	• the impact of those costs, fees, and embedded costs above on performance and client returns
	• compensation to the registered firm and registered individuals
	• conflicts of interest pertaining to:
	  ◦ compensation structure
	  ◦ related parties
	• assessment of how conflicts of interest will be addressed
	• additional training or proficiency requirements (including those pertaining to exempt securities)
	• consideration of competitive products that may be less costly or lower risk

Product Due Diligence Analysis	
Issuer, Portfolio Manager, Product Manufacturer, Sponsor	• financial position and history • track record • reputation of the company/issuer and senior management • qualifications and track record of senior management and key staff • conflicts of interest
Other	• custodian • guarantor • counterparties • other parties
Investor Profile	• investors who the product would be suitable for • investors who the product would not be suitable for • investor profiles including: ◦ personal circumstances ◦ financial circumstances ◦ investment needs and objectives ◦ risk profile ◦ time horizon ◦ investment knowledge • concentration limits • other restrictions/controls

The KYP obligation extends to all proprietary products of the firm including those of any related and connected issuers. Registered firms cannot simply rely on an assessment done by an affiliate or any other party; they must conduct their own KYP analysis which must encompass:

- Know Your Product (KYP) processes and selection criteria that is equivalent to those for non-proprietary products
- a market comparison analysis as a control on conflicts of interest associated with the use of the proprietary products
- periodic due diligence to evaluate whether proprietary products are competitive with comparable non-proprietary products available in the market

While firms may choose to make distinctions between the investment products it will make available to institutional clients and retail clients, the KYP requirements apply to both classes of investor.

Customarily, new exempt products will be announced in a "product release memo" or similar document which will summarize the salient features of the product.

RESPONSIBILITIES AND RESTRICTIONS OF THE DEALING REPRESENTATIVE

Your EMD's due diligence and approval of a product does not relieve you of your duty to understand the product to ensure that it is suitable for your client(s). Under the KYP obligation, you are required to learn the essential facts about each investment product and investment strategy in order to fulfill your suitability obligation. In doing so, you are required to take reasonable steps to understand each investment's structure, features, risks, initial and ongoing costs, and the impact of those costs.

Under Companion Policy (CP) 31-103, s. 13.2.1, you are also expected to:

- apply a more detailed consideration of investment products and strategies that are more complex or risky
- have a general understanding of the types of securities that are available through your firm in order to fulfill your obligation to consider a reasonable range of alternatives when making a suitability determination
- take reasonable steps to understand investments when acquired by transfer-in or by client-directed trade

Under your KYP obligation, you are required to:

- have a thorough understanding of the investment product and/or investment strategy
- clearly explain the investment product/strategy to your client(s)

In your explanation to clients, you are expected to cover the features summarized in the table below at minimum.

Product Features	
General Features and Structure	• investment mandate/objective • return • use of leverage • conflicts of interest • time horizon • overall complexity of the product
Risks	• liquidity risk • redemption risk • other product risks (e.g. from underlying derivatives, structured product risks, etc.)
Costs & Fees	• commissions • sales charges • trailer fees • management fees • performance fees • incentive fees • referral fees • embedded fees • executive compensation
Suitability	• how the product is suitable for the client

If a particular investment product is not aligned to a client's investment needs and objectives, risk profile, time horizon, financial circumstances, and/or personal circumstances, it should not be recommended to that client. Before submitting a transaction, you should be fully confident that the client, and not just you, understands the product/strategy and how it fits into their overall plan and goals. It is especially important that the client understands the downside risks of the investment so that if disaster befalls it, the client will have understood that it was a possibility.

While your EMD is not required to approve investment products that are transferred into their clients' accounts or those that are held as result of a client-directed trade, they are required to assess and understand the investment products within a reasonable time after the transfer or trade. You are required to take reasonable steps to understand those investments acquired by transfer-in or client-directed trade in order to fulfill your suitability obligation.

RISKS OF EXEMPT SECURITIES

In tandem with your KYP obligations specific to the features of investment products and strategies, it is equally important that you understand and explain to clients the unique features of exempt securities. It is your responsibility to make clients aware of the risks of investing in exempt securities including those summarized in the table below.

Risks of Exempt Securities	
Transparency	• exempt securities are not subject to the reporting issuer regime, they provide less information to their investors, and the information provided is not subject to the oversight of the regulators • not every exempt security will reveal their portfolio • it may be difficult for the client to ascertain whether the issuer is actually doing what it says it will do (i.e. whether it is adhering to its investment mandate, risk control process, trading discipline, and compliance processes)

Related Issuer	• where the EMD and the issuer are related parties, there is a conflict of interest
	• the EMD cannot recommend a trade in a security issued by it or an affiliate unless they first:
	  ○ consider and address the conflicts of interest in the best interests of the client(s)
	  ○ disclose the nature and extent of the relationship or connection between the EMD and the issuer before trade(s)

Independent Review Committee	• there is no Independent Review Committee (IRC) for non-public investment funds (e.g. hedge funds)
Liquidity Risks	• most exempt securities are subject to resale restrictions • there is no secondary market for exempt securities • the only means for liquidation may be through the issuer and if there is no redemption feature, the client will not be able to liquidate the securities at all • even exempt securities which offer redemption features often do so on a limited basis and, in most cases, the issuer also has the option to suspend redemptions

Risks of Exempt Securities	
Valuation Risk	• the accuracy and integrity of valuations can give rise to concerns which include: ◦ conflicts of interest ◦ accuracy of valuations
Investor Rights	• investors in exempt securities are not afforded the same legal rights that are available to investors who purchase prospectus-based investments • the right of action for damages for a "misrepresentation" are limited in comparison to prospectus-based securities
Investment Risk	• there is increased investment risk with exempt securities for the following reasons: ◦ the risk of smaller businesses, including those in the start-up phase, pose higher risks (e.g. junior mining and oil and gas companies) ◦ there is a higher risk of fraud due to the lack of transparency • there is the possibility that the client may lose some or all of the principal invested

UNAPPROVED INVESTMENT PRODUCTS AND STRATEGIES

Under the KYP obligation, you are prohibited from offering investment products or investment strategies that have not first been approved by your EMD.

Suitability 5

CONTENT AREAS

- Suitability
- Suitability Determination
- Account Type Suitability
- Risky Nature of Exempt Securities
- Concentration
- Tax-Advantaged Investments
- Leverage Suitability
- Treatment of Unsuitable Outcomes
- Client-Directed Trades
- Disclosure

INTRODUCTION

This unit takes approximately 20 minutes to complete.

LEARNING OBJECTIVES

At the end of this lesson, you will be able to:

1 | Provide an overview of the suitability obligation

2 | Explain suitability determination

3 | Discuss account type suitability

4 | Describe the risky nature of exempt securities

5 | Explain concentration risk as it relates to exempt securities

6 | Discuss the elements of tax-advantaged investments as they relate to suitability

7 | Explain how unsuitable outcomes should be treated

8 | Explain how client-directed trades should be treated

9 | Discuss the limitations of disclosure

SUITABILITY

The KYC and suitability obligations are the most fundamental and important duties of every Dealing Representative. The suitability obligation requires you to *know* the client, *know* the product, and to form an opinion as to whether the investment product is suitable for the client.

In order to conduct proper suitability assessments, you must first:

- Qualify the Client
- Know Your Client (KYC)
- Know Your Product (KYP)

You are obligated to ensure that any orders you accept and any recommendations you make are suitable based on the essential facts relative to your clients. However, the suitability obligation extends beyond orders and recommendations. You are required to make a suitability determination every time that you:

- open a new client account
- accept an order
- make a recommendation
- purchase, sell, deposit, exchange, or transfer investments for a client's account
- make a recommendation or decision to continue holding an investment
- take any other investment action for a client
- accept a client account (e.g. from another Dealing Representative)
- become aware of a material change in a client's circumstances

- become aware of a change in an investment within the client's account
- conduct a review of the client's KYC information
- exercise discretion, where permitted, to take any of the actions above

The regulators take the view that suitability determination should encompass not only the particular attributes of a security, viewed in isolation, but also the proposed *quantum of the investment amount* or the proposed *trading strategy* involving the security. CSA Staff Notice 31-336 provides the following example as guidance:

> *"…an investment in a high-risk security may be suitable for a client where the proposed investment would represent a small portion of the client's investment portfolio. However, an investment in the same security may not be suitable for the client where the proposed investment would represent a substantial portion of the client's portfolio or where the proposed investment strategy involves leverage."*

You cannot, under any circumstances, delegate your suitability obligation to another party such as an unregistered individual, an administrative assistant, a referral agent, or a registrant at another firm.

SUITABILITY DETERMINATION

Under NI 31-103 and CP 31-103, you are required to satisfy a number of standards when making a suitability determination:

1. assess suitable options;
2. apply the "Client's Interest First" standard; and
3. document the basis for each suitability determination.

ASSESSING SUITABLE OPTIONS

Suitability determination starts with the identification and assessment of suitable options for a client. This involves the objective analysis of the KYC information for the client and the KYP information for the investment product or strategy. The impact of the proposed action on the client's account must then be weighed to consider whether the account will be suitable for the client, after the action has been completed.

Assessing Suitable Options	
Know Your Client Information	**Know Your Product Information**
Risk Profile	**Risk rating from the:** • offering documents, for example: ○ offering memorandum, etc. • the registered firm's product approval notice
Investment Needs and Objectives	**Investment mandate/features based on the:** • offering documents, for example: ○ offering memorandum, etc. • the registered firm's product approval notice

Assessing Suitable Options	
Know Your Client Information	**Know Your Product Information**
Time Horizon and Age	**Time factors based on the:** • duration, maturity date • redemption features, schedules, restrictions • liquidity **Impact of costs:** • costs of disposing the investment product • the impact of those costs on performance returns
Investment Knowledge	**Structure and complexity**
After considering what the impact will be when the proposed action has been completed, the KYC and KYP information should be compared and used to consider whether: • the KYC and KYP are aligned and the investment product/strategy is deemed suitable after the consideration of reasonable alternatives available through the registered firm • the concentration of any investments within the account are over-weighted • the investments in the account provide sufficient liquidity to meet the client's liquidity needs	

Suitability assessment commonly starts with a comparison of the risk of the investment product/strategy compared to the risk profile of the client. This risk-based approach is an effective starting point and there are also correlations that can be made by comparing the KYC and KYP information related to investment objectives, time horizon, age, and investment knowledge. While these elements are key in determining suitability, all aspects of the client's KYC, the investment's KYP, and the client's existing holdings need to be considered.

As set out in CP 31-103, s. 13.3, suitability assessment:

- cannot use the risk rating of a security as the only input in determining its suitability
- cannot be determined only on a trade by trade basis

Suitability assessment must encompass a portfolio approach in order to consider the impact of factors such as risk, concentration of investments, and liquidity in the client's portfolio. Where client accounts are held separately in multiple accounts (e.g. client name), and not in one portfolio, you are expected to consider how any recommendations or other investment actions in one account will materially affect the client's investments across all of their accounts.

"CLIENT'S INTEREST FIRST" STANDARD

Following the assessment of suitable options for the client, you are then required to apply the "Client's Interest First" standard. Therefore, in addition to the consideration of KYC and KYP factors, you must assess whether the proposed action is one that puts that client's interest first.

"Client's Interest First" Standard

As set out in CP 31-103, s. 13.3:

> *"…when making a suitability determination, registrants must put the client's interest first, ahead of their own interests and any other competing considerations, such as a higher level of remuneration or other incentives."*

The regulators give further guidance in the CSA's Client Focused Reforms Frequently Asked Questions (FAQ), *s.18*:

> *"Among other considerations, putting the client's interest first requires registered firms and each of their registered individuals to avoid being influenced to make a self-interested choice in the particular circumstances of any given investment action. Examples of factors that might have such an influence include sales commissions, targets for sales volume or assets under management, client retention, and relationships with issuers. If any of these material conflicts of interest are present, the firm must have policies and procedures for addressing them as discussed above. Where material conflicts are present, they must be considered before any investment action is taken. In that context, the test is whether the registrant has put the client's interest first."*

With respect to exempt market products, the FAQ goes on to state:

> *"It also includes circumstances where a registrant has a limited product shelf. In some instances, a registrant will have to decline to provide a product or service to a client in order to put the client's interest first. For example, an EMD with a limited shelf might be unable (i) to conclude that any of its offerings are suitable for a client and (ii) put the client's interest first after taking into account the client's concentration in one security, sector or industry, high risk securities, or illiquid exempt market securities, or the direct and indirect costs, fees, commissions, charges, and registrant compensation which may be associated with their products, including embedded costs paid by the issuer. Registrants must document the reasonable basis for their suitability determinations, including how they have met their obligation to put the client's interest first."*

The obligation to put the client's interest first when determining suitability requires you to consider, amongst other factors, the potential (or actual) impact of costs on the client's return on investment. Costs include all direct and indirect costs, such as:

- fees
- commissions
- charges
- trailing commissions
- any other costs associated with a proposed action

You are expected to assess both the:

- relative costs of the options available to clients
- impact of those costs on the client's overall return from any compensation paid, directly or indirectly, to you

As per the guidance in the CSA's Client Focused Reforms Frequently Asked Questions, s.47:

> *"This requirement includes considering the impact of all direct and indirect costs which may be associated with a product, including embedded costs paid by the issuer. In this regard, it is not appropriate for registrants, including EMDs, to rely solely on forward looking information about the issuer's potential returns that is provided in the issuer's offering documents. Registrants, including EMDs, should perform their own assessment of the potential and actual impact of costs on the client's return on investment when making a suitability determination."*

Some investment products or strategies that are assessed to be suitable for a client, based on KYC and KYP, may not meet the "Client's Interest First" standard.

EXAMPLE

On July 5, 2021, Tyler Davidson (Davidson) and the Mutual Fund Dealers Association of Canada (MFDA) consented to a Settlement Agreement. Under the agreement, Davidson admitted that he recommended a trade in a deferred sales charge (DSC) investment fund that needlessly subjected his client to a seven-year redemption schedule and other costs, while it generated commissions for himself.

The case involved Davidson's sale of the DSC version of an investment fund to a client when the investment amount qualified her for the lower cost I-Program version of the fund. By investing the client in the DSC version of the fund, the client was needlessly subjected to a 7-year redemption schedule, higher management fees by 20-35 basis points, redemption fees of $17,200, additional redemption fees on subsequent related transactions in the client's registered retirement savings plan (RRSP), and interest charges on a line of credit that the client took to avoid further redemption fees on amounts needed for a down payment on a home. Davidson earned $15,346 in commissions by investing the client in the DSC version of the fund. In doing so, Davidson violated MFDA Rules 2.1.1 (Standard of Conduct), 2.1.4 (Conflicts of Interest), and 2.2.1 (Suitability).

The Settlement Agreement was accepted by the MFDA Hearing Panel on July 12, 2021 and the following settlement terms were ordered: **A one month prohibition, a fine of $22,500, and costs of $5,000.**

As set out in CP 31-103, s. 13.3, where you are not able to offer a client an investment option that is suitable and puts the client's interests first because the option is not available through your EMD, the regulators expect you to decline the client's account.

DOCUMENTING THE BASIS FOR SUITABILITY DETERMINATION

Once a suitability determination has been made, you are required to document the reasonable basis for your suitability determination and how you have met your obligation to put the client's interest first including the:

- relevant facts
- key assumptions
- scope of data considered
- analysis performed

ACCOUNT TYPE SUITABILITY

You and your EMD are subject to the suitability obligation for all proposed investment actions, including opening an account for a client. As outlined in CP 31-103, s. 13.3(c), you are expected to ensure that the opening of a new account:

- is suitable for the client
- puts the client's interest first

In determining whether an account is suitable for a client and whether the account puts the client's interest first, you are expected to consider the:

- type of account recommended
- compensation option(s)
- nature of the service offered to the client
- investment strategies such as leverage

- features and associated costs, for example for:
  - fee-based accounts
  - commission-based accounts

Before the account is opened, you are expected to explain the features and associated costs of different types of accounts that are available to the client at the firm.

RISKY NATURE OF EXEMPT SECURITIES

The risky nature of many exempt securities has the following implications:

- These products are most suitable for an investor whose investment needs and objectives are growth or speculation.
- An investment in these products is most suitable for investors with a risk profile at the high end of the spectrum.
- These products are subject to resale restrictions, there is no secondary market, and the lock-up periods could be indefinite in some cases. As such, these products are most suitable for investors with a long time horizon who are not seeking liquidity in the investment.
- These products are appropriate only for investors who can afford the loss of their entire investment. Given the risk of total loss, you should ensure that an investment in these products represents only a small percentage of the investor's net worth.
- Since many exempt products require a high minimum investment, they may only be appropriate for high-net-worth investors.
- The investor should have sufficient investment knowledge to understand the product and its associated risks.

CONCENTRATION

Concentration is an integral element in the consideration of suitability. It is considered high risk to have portfolios which hold assets that have high correlations to each other such as investment type, sector, asset class, geographic region, risk, etc. From the perspective of the exempt market, factors impacting correlation would include securities in the exempt market as a whole, securities of the same issuer, securities of a related issuer, etc. All would result in high correlation. These high correlations reduce diversification and increase risk from concentration.

The securities regulators take the view that suitability should encompass not only the particular attributes of a security, viewed in isolation, but also the proposed *quantum of the investment amount* or the proposed *trading strategy* involving the security. As such, portfolios which are over-concentrated could pose suitability concerns.

Under National Instrument (NI) 31-103, s. 13.3, *Suitability Determination,* "the impact of the action on the client's account, including the concentration of securities within the account and the liquidity of those securities" must be factored into any suitability determination.

Companion Policy (CP) 31-103, s. 13.3 further explains the regulators' expectations with respect to concentration:

> "…*registrants should assess whether the client's investments are over-concentrated in:*
>
> - *illiquid exempt market securities as compared to more liquid publicly traded securities,*
> - *securities of a single issuer, or group of related issuers, as compared to a broadly- based portfolio of issuers, or*
> - *securities of an issuer, or group of related issuers, that provides exposure to a single industry or asset class…*"

Given the fact that the securities regulators regard exempt securities as higher risk investments, portfolios with high weightings in exempt securities would be seen as having significant risk, particularly where they have high correlations to each other.

CSA Staff Notice 31-336 states:

> *"…staff will consider investments (either individually or taken together with prior investments) in securities of a single issuer or group of related issuers that represent more than 10% of the investor's net financial assets as potentially raising suitability concerns due to concentration."*

In deciding what percentage of a client's total portfolio (taking into account assets both inside and outside the EMD) is to be invested, you must consider:

- the type of security
- the asset class of the security
- the sector of the security
- the geographic region of the security
- liquidity restrictions
- the risk of the security
- the client's portfolio as a whole including:
    - what portion of the client's portfolio is invested in the exempt market as a whole
    - what portion of the client's portfolio is invested in securities of the same issuer or related issuers

You are expected to consider and document reasonable concentration thresholds to ensure that a client's investment does not exceed concentration thresholds which would result in the investment being unsuitable.

The higher the concentration in exempt products, particularly those with high correlations to each other, the more steps you must take to demonstrate that the investment is suitable. You are also obligated to explain the concentration risk to the client and you should document your assessments and explanations as a best practice.

Over-concentration in an investment, sector, geographic region, etc. can impact the risk and liquidity in a client's account. Generally speaking, the higher the concentration, the more detailed your analysis and justification should be. The onus will be on you to demonstrate and evidence how and why any concentrated positions are suitable for the client(s) and put the clients' interests first.

TAX-ADVANTAGED INVESTMENTS

Certain exempt securities, such as flow-through shares and flow-through limited partnerships, enjoy tax benefits which significantly enhance their potential return. The tax benefit is highest for investors who are subject to income tax at the top marginal rate. However, regardless of any tax benefits, investment products must be approached first and foremost as an investment. A decision to invest should be based primarily on an appraisal of the merits of the investment. The investor's risk profile is a critical factor, in particular their ability to absorb losses and in the case of flow-through shares, their willingness to invest in speculative junior resource companies. Volatility in the resource sector can be high and returns are unpredictable.

As with any complex tax-driven investment, investors should consult with a qualified tax advisor to determine if the tax benefit is appropriate for them. While the tax advantages of a flow-through investment are important, they should not be an investor's only consideration.

LEVERAGE SUITABILITY

The suitability obligation extends beyond investment products and you are required to make a suitability determination to assess whether any investment strategy is suitable for a client. Under NI 31-103, s. 13.3(1), suitability must be assessed before you take any "investment action" for a client.

In particular, you are required to determine whether it is suitable for an investor to borrow money in order to invest, also known as "leverage suitability". As set out in Companion Policy (CP) 31-103, s. 13.2, *Leverage or borrowing to finance the purchase of securities*, you are expected to:

- understand whether or not a client is using leverage or is borrowing to finance the purchase of securities
- gather additional details regarding the client's ability to meet debt obligations
- make a suitability determination

LEVERAGE RISK DISCLOSURE

You must provide the prescribed Leverage Risk Disclosure to all clients who invest using borrowed funds. Before proceeding with an investment strategy using borrowed funds, you must provide the leverage risk disclosure prescribed under National Instrument (NI) 31-103, s. 13.13:

> *"Using borrowed money to finance the purchase of securities involves greater risk than a purchase using cash resources only. If you borrow money to purchase securities, your responsibility to repay the loan and pay interest as required by its terms remains the same even if the value of the securities purchased declines."*

However, providing the disclosure does not relieve you of your suitability obligation. It is your duty to ascertain whether leverage is suitable for any given client, regardless of the fact that you must provide the Leverage Risk Disclosure.

TREATMENT OF UNSUITABLE OUTCOMES

Where you determine that an action in a client's account will result in an outcome that is unsuitable for the client, you are required to advise the client accordingly, make recommendations to address the suitability issue(s), and maintain evidence of your recommendations. Alternative recommendations to address suitability issue(s) may include:

- selling the unsuitable investment (where applicable/permitted)
- not buying the unsuitable investment (in the case of a proposed transaction)
- cancelling or reversing the trade in the unsuitable investment at no cost to the client
- recommending other, off-setting trades or transactions in the account to bring the account "in line" with the client's KYC and objectives
- reviewing and updating the client's KYC information, if appropriate (where the client's circumstances and/or objectives have changed)

Making unsuitable recommendations or failing to address unsuitable outcomes may have severe consequences for you and for your firm, which may include:

- client complaints against you and your EMD
- internal investigation by your EMD
- an external enforcement investigation by the securities regulator(s)

When you are required to re-assess suitability under one of the suitability triggers (e.g. when a KYC review is triggered, when you become aware of a change in an investment, etc.), there may be limitations to the options to rectify what has become an unsuitable investment. There may be little you can do when an exempt market product is illiquid or has constraints on the redemption rights of the investor. As per guidance provided in the CSA's Client Focused Reforms Frequently Asked Questions, s.49, in such cases you would be expected to:

- take "reasonable steps" to explore the possibility of redeeming the investment
- in consideration of penalties, discounts, or other factors that would be detrimental to the client's interest, make a determination of whether a redemption would be suitable
- document the basis for the suitability determination and the discussion with the client
- take this fact into account when making future recommendations for the client, including any additional investments

CLIENT-DIRECTED TRADES

Client-directed trades, also known as unsolicited trades, are those which are initiated by the client without recommendation from you or your EMD. Client-directed trades must also be assessed for suitability. If you receive instructions from a client which, in your view, will result in an unsuitable outcome, you are required to:

- inform the client that the transaction is not suitable and provide the basis of your suitability determination
- recommend alternative action which is suitable
- obtain recorded confirmation of the client's instruction where they proceed with the action despite your suitability determination

You and your EMD are under no obligation to accept a trade from a client that is determined to be unsuitable. Whether an EMD should accept or refuse such a trade is an internal policy decision and you will need to consult with your EMD. If your client proposes a trade or action that you believe is unsuitable, and you are unclear how to proceed after providing the required suitability determination and alternatives, then you should consult your EMD for guidance.

You cannot actively promote or recommend a security and then rely on client-directed disclosure as proof that you did not recommend an investment. The securities regulators take a dim view of situations where it appears that disclosure for client-directed trades is used as a means to evade suitability obligations and they have outlined their issues in this regard in CSA Staff Notice 31-336.

With respect to the Offering Memorandum (OM) exemption, a number of provinces including Ontario require Dealing Representatives to make a *positive suitability determination* before they are permitted to make a recommendation to exceed the $30,000 investment threshold for eligible investors. As such, you cannot rely on a client-directed trade to permit a higher investment amount up to the $100,000 limit. The requirement to make a *positive suitability determination* forms part of the OM Exemption itself.

DISCLOSURE

It is important that you understand that disclosure does not justify an unsuitable recommendation. For example, a recommendation to a client with a medium risk profile to purchase a high-risk investment is unsuitable, even if the client is provided with disclosure that shows the investment is high-risk. Thus, the fact that a client has been given a risk acknowledgement that fully discloses that an exempt investment is high-risk does not justify selling the security to a client with a medium risk profile.

EXAMPLE

In June 2020, a Hearing Panel of the Alberta Securities Commission in Re Rustulka[2] determined that a former Dealing Representative of an exempt market dealer had breached his KYC and suitability obligations. In its discussion and conclusion on the suitability obligation, the Hearing Panel noted that the obligation to complete the suitability assessment remains with the registrant:

> *"[228] …we reiterate that a registrant's suitability obligation is not discharged just because a client has said that he or she knew of or accepted the risk of an investment, or because he or she has signed documents to that effect. We agree with the panel in Lamoureux that, "no amount of disclosure to the investor, or acknowledgement by the investor, can convert an unsuitable investment into a suitable investment" (at p. 28) or displace a registrant's obligation to conduct a proper suitability assessment (at p. 16). We also agree with the comments of the panel in Daubney (at paras. 201, 210):*
>
> *While we recognize that clients have responsibilities to understand the potential risks and returns on their investments, this does not relieve [the registrant] of his duty…to make certain that they have this understanding and to make appropriate recommendations, especially in circumstances where he is dealing with investors who have relatively little investment experience.*
>
> *…While investors are well[-]advised to be cautious in choosing investments, the Act places the duty of care on the registrant, who is better placed to understand the risks and benefits of any particular investment product. That duty cannot be transferred to the client."*

Disclosure does not, under any circumstances, relieve you from your suitability obligation.

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Dealing with Older and Vulnerable Clients

6

CONTENT AREAS

INTRODUCTION

This lesson takes approximately 10 minutes to complete.

LEARNING OBJECTIVES

At the end of this lesson, you will be able to:

1 | Provide an overview of the requirements for dealing with older and vulnerable clients

2 | Explain the requirements for establishing a Trusted Contact Person (TCP)

3 | Explain the requirements governing temporary holds

4 | Discuss the firm's policies and procedures for dealing with older and vulnerable clients

DEALING WITH OLDER AND VULNERABLE CLIENTS

Specific attention is required when dealing with investors who fall into the "senior" category, defined as individuals over the age of 65, and other vulnerable investors. Canadian securities regulators have established legislation and regulations with the purpose of protecting older and vulnerable clients.

In general, older clients are thought to have limited ability to replenish capital losses through future income from other sources. As a broad rule, older clients typically have:

- investment objectives that emphasize safety of capital and income rather than growth
- lower risk profile than younger investors
- shorter time horizons than younger investors

It is also important to recognize that older clients may have unrealistic expectations for investment income. They need their investments to generate a certain level of income in order to maintain certain expenditure levels or avoid dependency on family members. However, stable, lower risk income products are generally not available in the exempt market.

Figure 12.1

Notwithstanding the generalities concerning older clients, every individual is unique and the suitability process should accommodate the uniqueness of every client. However, the onus will be on you to demonstrate and evidence how and why an older client is an exception to the general rules.

EXAMPLE

Luisa is your client. She is 70 years old and actively running her own real estate brokerage. She has a net worth of well over $2 million and an annual income in excess of $400,000. Luisa is a sophisticated investor who has invested in options in the past and has experience with short-selling. As her Dealing Representative, you feel confident that an exempt market security you are selling is suitable for her and you put Luisa's interests first when making your determination. You explain your reasons to Luisa and she agrees. You document your reasons and your conversation with Luisa.

Vulnerable clients are defined as those individuals who might have an illness, impairment, disability, or aging-process limitation that places them at risk of financial exploitation. Financial exploitation is when a person or company uses, controls, or deprives the use or control of an individual's financial assets through undue influence, unlawful conduct, or another wrongful act.

Extra caution should be exercised when dealing with older and vulnerable clients, especially if engaged in higher risk investments or strategies, or those that deplete capital through withdrawals that exceed returns. Generally speaking, leverage is not typically appropriate for older or vulnerable clients due to their lesser ability to withstand losses and their diminished ability to replenish capital.

Other risks that have come to the forefront with respect to older and vulnerable clients are those involving reduced mental capacity. Older and vulnerable clients can be susceptible to physical or cognitive impairments which call into question their ability to properly understand the risks of investing in the exempt market and to instruct you in a meaningful way.

As a result, specific regulatory requirements have been established to place responsibility on you to:

- take reasonable steps to designate a Trusted Contact Person (TCP) for each client
- follow your EMD's procedures for placing temporary holds on accounts, where the firm permits, when you reasonably believe that the client:
  - is at risk of being exploited financially
  - does not have the mental capacity to make a financial decision for their account

TRUSTED CONTACT PERSON

Under National Instrument (NI) 31-103, s. 13.2.01, you have a duty to take reasonable steps to designate a Trusted Contact Person (TCP) for each client including:

- the name and contact information for the TCP
- written consent from the client to contact the TCP in prescribed circumstances

Designating a TCP for each client is meant to help clients plan and prepare for their senior years and other special challenges that could affect them including cognitive decline, diminished capacity, and financial exploitation. By designating the TCP, you and your EMD are authorized to speak to the TCP should they become concerned about the client's welfare concerning:

- financial exploitation of the client
- the client's mental capacity to make a financial decision for their account

You and your EMD are also authorized to speak to the TCP in order to ask questions about the:

- client's current contact information
- name and contact information for a legal representative of the client

TCPs must be over the age of majority and are often family members or caregivers of the client. However, those who have an interest in the client's account or assets, such as a beneficiary, or those involved in making financial decisions for the account, such as a Power of Attorney (POA), should not be designated as a TCP. Designating a TCP does not bestow any power to the TCP to make changes to the client's accounts or their financial dealings in any way. As such, the TCP should not be considered an alternative to a Power of Attorney (POA).

You are required to take reasonable steps to maintain current records pertaining to the TCP and update those records within a reasonable time when there are significant changes made to the client's KYC information.

You should follow your EMD's policies and procedures for designating TCPs, which might typically include procedures to ask clients to consider naming a TCP when:

- the new account is opened
- the KYC information is updated

TEMPORARY HOLDS

Under NI 31-103, s. 13.19, EMDs are permitted to place a temporary hold on a client's account should they reasonably believe that the client is a vulnerable client and is either at risk of being exploited financially or at risk because they do not have the mental capacity to make the financial decision related to an instruction for their account.

By placing a temporary hold on an account, the EMD may temporarily disallow a:

- withdrawal, liquidation, or transfer of cash or securities from an account
- purchase or sale of a security

Temporary holds can be applied at the transaction level, but not at the level of the entire account. A temporary hold must be limited to a specific transaction (e.g. a withdrawal, liquidation, transfer, etc.) and each transaction should be reviewed separately. Any transactions unrelated to the financial exploitation or lack of mental capacity should proceed free of hold.

Under guidance in Appendix G, Part 13 of Companion Policy (CP) 31-103, temporary holds must be approved by designated persons such as the Chief Compliance Officer or authorized and qualified supervisory, compliance, or legal personnel.

Conditions for Temporary Holds	
Condition 1: A temporary hold may **only** be placed on a client's account if the EMD reasonably believes that:	• the client is a vulnerable client; and • an attempt has or will be made to exploit the client financially, or the client has already been exploited financially; or • the client does not have the mental capacity to make financial decisions related to the instruction given by the client.
Condition 2: Where an EMD places a temporary hold on an account based on the foregoing, the EMD must:	• document the facts that resulted in the EMD's decision to place the temporary hold • promptly, as soon as possible, provide notice of the temporary hold to the client, with reasons • promptly, as soon as possible, review the facts that resulted in the EMD's decision to place the temporary hold to determine if continuing the hold is appropriate

Conditions for Temporary Holds	
	• review the facts on a reasonably frequent basis to determine if continuing the hold is appropriate • within 30 days and each subsequent 30-day period determine either to: ○ terminate the temporary hold ○ proceed or not proceed with the withdrawal(s), liquidation(s), transfer(s), purchase(s), or sale(s) of securities • provide the client with notice of the EMD's decision, with reasons, where it decides not to terminate the temporary hold

WHERE FIRMS ARE NOT OBLIGATED

It is important to note that EMDs are not obligated to place temporary holds on accounts under regulatory requirements. Given that there is no "safe harbour" to protect registered firms from disputes should trading losses arise from unexecuted transactions, EMDs will need to consider the potential risks from trading losses. While safe harbours exist in other jurisdictions, such as the US, there is no such protection for registered firms in Canada. Therefore, EMDs will need to consider these risks when determining whether or not they will structure their programs to include temporary holds.

RECOGNIZING COGNITIVE DECLINE AND FINANCIAL EXPLOITATION

The regulators have provided good guidance on how Dealing Representatives can recognize cognitive decline and financial exploitation. In particular, Companion Policy (CP) 31-103, provides the CSA's definitions of financial exploitation and decline in mental capacity in Appendix G of the policy.

Registered firms, including EMDs, are expected to have policies and procedures for dealing with older and vulnerable clients which should include the detailed warning signs of financial exploitation and decline in mental capacity.

Figure 12.2

POLICIES AND PROCEDURES FOR DEALING WITH OLDER AND VULNERABLE CLIENTS

Summarized below are some of the critical elements that an EMD's policies and procedures for dealing with older and vulnerable clients might typically include.

Policies and Procedures for Dealing with Older and Vulnerable Clients	
New Client Account Documents and Relationship Disclosure Information (RDI)	New client account documents for collecting the: • name and contact information for the TCP • consent from the client to contact the TCP Relationship Disclosure Information (RDI) to disclose the circumstances where the registered firm will: • contact the TCP • place a temporary hold on the account
Policies and Procedures (PPM)	Policies and procedures for: • collecting information and consent to designate the TCP • contacting the TCP • recognizing the warning signs of financial exploitation and decline in mental capacity • addressing and escalating matters within the EMD • requesting, reviewing, and approving temporary holds • the designated persons authorized to approve temporary holds • the persons responsible for monitoring temporary holds • escalating matters to the authorities • records to be retained for TCPs, temporary holds, and escalations
Training	Training for Dealing Representatives on: • how to deal with older and vulnerable clients • how to recognize cognitive decline and financial exploitation • the firm's policies and procedures for older and vulnerable clients, TCPs, temporary holds, and escalations

UNIT SUMMARY

Congratulations, you have reached the end of Unit 12: KYC & Suitability

In this unit you covered:

- Lesson 1: Overview of Suitability
- Lesson 2: Exemption Qualification
- Lesson 3: Know Your Client
- Lesson 4: Know Your Product
- Lesson 5: Suitability
- Lesson 6: Dealing with Older and Vulnerable Clients

Now that you have completed these lessons, you are ready to assess your knowledge with a 10-question quiz. To start the quiz, return to the IFSE Landing Page and click on the Unit 12 Quiz button.

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