
THE ASSET MANAGEMENT REVIEW

FIFTH EDITION

EDITOR
PAUL DICKSON

LAW BUSINESS RESEARCH

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Fifth Edition

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PAUL DICKSON

LAW BUSINESS RESEARCH LTD

PUBLISHER
Gideon Robertson

SENIOR BUSINESS DEVELOPMENT MANAGER
Nick Barette

BUSINESS DEVELOPMENT MANAGER
Thomas Lee

SENIOR ACCOUNT MANAGERS
Felicity Bown, Joel Woods

ACCOUNT MANAGERS
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Adam Myers

PRODUCTION EDITOR
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SUBEDITOR
Janina Godowska

CHIEF EXECUTIVE OFFICER
Paul Howarth

Published in the United Kingdom
by Law Business Research Ltd, London
87 Lancaster Road, London, W11 1QQ, UK
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www.TheLawReviews.co.uk

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ISBN 978-1-910813-27-0

Printed in Great Britain by
Encompass Print Solutions, Derbyshire
Tel: 0844 2480 112

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ACKNOWLEDGEMENTS

The publisher acknowledges and thanks the following law firms for their learned assistance throughout the preparation of this book:

ADVOKATFIRMAET BA-HR DA

APPLEBY

ARTHUR COX

BONELLIEREDE

CYRIL AMARCHAND MANGALDAS

DE BRAUW BLACKSTONE WESTBROEK NV

DE PARDIEU BROCAS MAFFEI

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FANGDA PARTNERS

HENGELER MUELLER

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LIEDEKERKE WOLTERS WAELEBROECK KIRKPATRICK

MANNHEIMER SWARTLING ADVOKATBYRÅ AB

MAPLES AND CALDER

MORI HAMADA & MATSUMOTO

PINHEIRO NETO ADVOGADOS

ROPES & GRAY LLP

Acknowledgements

SLAUGHTER AND MAY

STIKEMAN ELLIOTT LLP

TSMP LAW CORPORATION

UDO UDOMA & BELO-OSAGIE

URÍA MENÉNDEZ

WIEDENBAUER MUTZ WINKLER & PARTNER

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EDITOR'S PREFACE

While the global financial crisis of 2007–2008 may feel like an increasingly distant memory, its effects continue to be felt across the whole of the financial world. Despite significant improvements in the global economic landscape in the intervening years, global growth was hampered in 2015 by various geopolitical factors, including a slowdown of economic activity in China and weakening energy and commodity prices. In the UK, the prospect of the referendum on membership of the EU in June 2016 created an uncertain political environment. The impact of the UK's decision to leave the EU is expected to be significant, in particular for the UK and across the European continent but also more widely.

Nevertheless, the importance of the asset management industry continues to grow. Nowhere is this truer than in the context of pensions, as the global population becomes larger, older and richer, and government initiatives to encourage independent pension provision continue. By way of example, in the UK, changes to the rules governing what retirees can do with their pension benefits are creating new opportunities and challenges for discretionary managers and product providers.

The activities of the financial services industry remain squarely in the public and regulatory eye, and the consequences of this focus are manifest in ongoing regulatory attention around the globe. Regulators are continuing to seek to address perceived systemic risks and preserve market stability through regulation. In Europe, major changes to the regulatory landscape for investment funds were introduced by the Alternative Investment Fund Managers Directive, which has applied in full since July 2014, and more recently by certain changes to the UCITS regime. The next key regulatory milestone in the investment business space – the revisions to the Markets in Financial Instruments package – has been delayed by a year, reflecting the challenges for implementation of such significant and wide-reaching regulatory reforms. In the UK, the Financial Conduct Authority continues to focus on the asset management industry. In 2015, a market review of financial advice was completed, and a wide-ranging market study on the industry and the charges it levies on investors was launched.

It is not only regulators who continue to place additional demands on the financial services industry in the wake of the financial crisis; the need to rebuild trust has led investors to call for greater transparency around investments and risk management from those managing

their funds. Industry bodies have noted further moves away from active management into passive strategies, illustrating the ongoing pressure on management costs. The increasing impact of technology on the industry has also been observed, including developments such as 'smart beta' management strategies and the nascent emergence of automated (or 'robo') advice services.

This continues to be a period of change and uncertainty for the asset management industry, as funds and managers act to comply with regulatory developments and investor requirements and adapt to the changing geopolitical landscape. Although the challenges of regulatory scrutiny and difficult market conditions remain, a return of risk appetite has also evidenced itself. The industry is not in the clear but, prone as it is to innovation and ingenuity, it seems well placed to navigate this challenging and rapidly shifting environment.

The publication of the fifth edition of *The Asset Management Review* is a significant achievement, which would not have been possible without the involvement of the many lawyers and law firms who have contributed their time, knowledge and experience to the book. I would also like to thank Gideon Robertson and his team at Law Business Research for all their efforts in bringing this edition into being.

The world of asset management is increasingly complex, but it is hoped that the fifth edition of *The Asset Management Review* will be a useful and practical companion as we face the challenges and opportunities of the coming year.

Paul Dickson

Slaughter and May

London

September 2016

Chapter 8

CANADA

Alix d'Anglejan-Chatillon and Jeffrey Elliott¹

I OVERVIEW OF RECENT ACTIVITY

Canada has a mature, competitive and well-regulated asset management sector, which has remained buoyant (along with the Canadian economy generally) despite the pressures caused by the global financial crisis of 2007/2008. Nonetheless, the Canadian economy is currently exhibiting signs of slowdown due to, among other factors, the recent sharp decline in the price of benchmark crude oil and increases in household debt levels. While the global economic downturn and concomitant scandals have arguably caused some degree of increased regulatory scrutiny of asset managers and their activities in Canada, this has so far not resulted in much in the way of (knee-jerk) redesign of the regulatory system. Rather, the most significant recent regulatory initiative in this area by and large took root prior to the economic crisis, culminating in late 2009 in the form of a complete revamping of the dealer, adviser and investment fund manager registration framework in Canada. Adjuncts to this initiative, such as the non-resident investment fund manager registration requirements noted below, as well as consequential clarifying amendments to the initial reforms, have been proposed in the years since.

II GENERAL INTRODUCTION TO THE REGULATORY FRAMEWORK

Outside the specific rules that apply to the regulation of the management of insurance and pension fund assets (described briefly below), the overriding regulatory framework applicable to asset management in Canada is that contained in securities laws. In Canada, securities regulation is a matter of provincial and territorial jurisdiction. Each of the 10 provinces and three territories has its own securities laws, policies and rules that are administered by a local securities regulatory authority. However, in many areas, including in respect of the

¹ Alix d'Anglejan-Chatillon and Jeffrey Elliott are partners at Stikeman Elliott LLP.

distribution of securities to sophisticated parties and the registration of market participants in the asset management arena, the rules have been largely harmonised among the jurisdictions so that compliance with the harmonised national rules will generally result in compliance with the rules in all jurisdictions.

i Prospectus requirements and exemptions

Asset managers purchasing securities for funds that they manage or offering securities in those funds to Canadian investors must do so on the basis of a prospectus or in reliance on a prospectus exemption. The exemption most frequently used among the capital-raising exemptions in Canada is the accredited investor exemption. This exemption is available in respect of sales of securities to qualified entities and individuals that are deemed sufficiently sophisticated that they do not require the protection that prospectus disclosures are intended to provide. Included among the qualified entities – many of which are advised by asset managers – are certain types of banks and other financial institutions, trust companies, pension funds, registered charities, investment funds, domestic and international governmental bodies, and entities other than individuals or investment funds with net assets of C\$5 million or more. An individual may also qualify as an accredited investor if he or she, alone or with a spouse, owns financial assets having an aggregate net realisable value over C\$1 million; has net assets of at least C\$5 million; or has net income before taxes in excess of C\$200,000 alone, or C\$300,000 together with his or her spouse. Canadian securities authorities have stated that it is not sufficient to rely on a bare representation of a purchaser's status as an 'accredited investor' and, where necessary, further inquiries must be made of investors to verify the eligibility represented by an investor under a specific category.

The offering of a security by way of prospectus exemption, such as the accredited investor exemption, does not require that a written document describing the business and affairs of an issuer be provided to prospective purchasers. However, if any written document is provided, it may constitute an offering memorandum under the securities legislation of some provinces in Canada, which is required to include certain prescribed disclosure, including disclosure relating to purchaser statutory rights of action for damages or rescission where the offering memorandum contains a misrepresentation, and disclosure relating to certain conflicts of interest. Issuers of eligible foreign securities may avail themselves of exemptions from the requirement to disclose some of this information provided that certain conditions are met, including that distributions be limited to qualified 'permitted clients'.

It should be noted that securities purchased pursuant to a prospectus exemption are subject to resale restrictions or hold periods. For a private fund with securities that are never listed on a Canadian stock exchange, this effectively means that its securities will never be freely tradeable in the Canadian market. However, leaving aside contractual restrictions in a fund's formation documents, such securities can be traded or transferred pursuant to a further prospectus exemption (e.g. to another accredited investor). In addition, when securities are issued from treasury pursuant to certain private placement exemptions, the issuer is required to file a report of trade with the securities regulators in each Canadian jurisdiction in which the securities are sold, generally within 10 days of the distribution. Effective 30 June 2016, the form required to report private placements was amended to impose enhanced disclosures, including (as applicable) net proceeds by jurisdiction, most recent net asset value and the type of investment fund issuer. In most jurisdictions, the filing of the report is also subject to the payment of a regulatory filing fee, and a copy of any offering memorandum that is delivered

to investors must also be delivered to the local regulator. Finally, the issuer must retain a copy of a completed risk acknowledgement form signed by individual accredited investors other than those with financial assets in excess of C\$5 million.

ii Registration requirements

Asset managers, and those distributing securities to asset managers, may be subject to several types of registration under Canadian securities law. The registration requirements and ongoing registrant obligations are stringent and comprehensive.

National Instrument 31-103 Registration Requirements, Exemptions and Ongoing Registrant Obligations (NI 31-103) establishes registration requirements and exemptions, and sets out the categories of registration; the proficiency, capital, insurance and other basic requirements for registration; and the ongoing requirements regarding internal controls and systems, financial condition and reporting, dealing with clients and handling client accounts. Under Canadian securities laws, firms generally must register if they are in the business of trading, in the business of advising, holding themselves out as being in the business of trading or advising, or if they act as an investment fund manager. If a firm engages in more than one of these registrable activities, then (unless it is otherwise exempt) the firm must register in all applicable categories.

Dealer registration

Persons who are in the business of trading in securities are required to be registered as a dealer in each Canadian jurisdiction where purchasers reside. Trading is broadly defined under Canadian securities laws to include not only the sale or disposition of a security for valuable consideration, but also any act, solicitation or conduct that is directly or indirectly in furtherance of the sale or disposition of a security. Accordingly, an asset manager that is not registered as a dealer is generally not permitted to contact and deal directly with prospective clients. Any such contact would generally be considered an act in furtherance of a trade and may accordingly trigger the dealer registration requirement. There are limited exemptions. This means that an asset manager wishing to distribute securities in Canada of a fund that it manages, or a Canadian asset manager wishing to purchase securities for portfolios that it manages, must generally do so through an appropriately registered dealer.

Where securities are being privately placed, the dealer registration requirement may be satisfied through the use of an exempt market dealer (EMD). An EMD is permitted to trade in the exempt market in securities being distributed under a prospectus exemption, or with persons or companies to whom a security may be distributed under a prospectus exemption (e.g., trading with an accredited investor). Under recent amendments, EMDs are now expressly prohibited from engaging in brokerage activities, including trading securities listed on an exchange in foreign or Canadian markets.

A second dealer category is that of an investment dealer that, unlike an EMD, may trade in virtually any security with any client, including retail clients, provided that the securities offered are covered by a prospectus (subject to know-your-client and trade suitability requirements).

A non-Canadian dealer that is appropriately registered or licensed in its home jurisdiction may make a filing to rely on the international dealer exemption in a Canadian jurisdiction, which would allow it to place foreign securities (i.e., securities issued by issuers established outside of Canada) to permitted clients (a subset of accredited investors), provided a number of other conditions are met.

Firms registered in the category of restricted dealer (which is subject to firm-specific business restrictions) may also be appropriately registered to intermedate a private placement of fund securities.

Adviser registration

Canadian securities laws require a person or company engaging in, or holding itself out as engaging in, the business of advising others in respect of the buying, selling or investing in securities to be registered as an adviser in the local jurisdiction where advice is received. Again, there are limited exemptions to this requirement. A non-Canadian firm that is registered or exempt from registration in its home jurisdiction may make a filing to rely on the international adviser exemption provided, among other conditions, that it acts as an adviser to permitted clients (that are not registered as advisers or dealers in a Canadian jurisdiction) and does not advise on securities of Canadian issuers unless that advice is incidental to its advice on a foreign security. The provision of general advice not purporting to be tailored to the needs of the recipient of the advice may also be exempt, subject to disclosure and other conditions. An exemption is also available for unregistered foreign advisers entering into written sub-advisory agreements with a registered adviser or dealer, subject to certain terms and conditions. Significantly, certain Canadian securities regulators once took the view that advice provided outside of Canada to a non-Canadian investment fund flows through to Canadian investors in the fund. That position, however, has been discontinued, and non-Canadian advisers to funds established outside Canada are no longer subject to adviser registration solely as a result of the issuance of securities of the investment fund to Canadian-resident investors.

Investment fund manager registration

Canadian securities laws require a person who directs or manages the business, operations or affairs of an investment fund to be registered as an investment fund manager (IFM) in the province or territory in which its head office is located. A non-resident IFM is required to register in Ontario, Quebec, and Newfoundland and Labrador if the fund the IFM manages has security holders that are resident in those jurisdictions, and the IFM or the fund it manages has actively solicited local residents to purchase securities of the fund after the effective date of the rule. There is an exemption from this requirement to the extent that, among other conditions, the securities of the fund that the IFM manages are distributed only to permitted clients and certain other filings are made with the applicable securities regulators. Non-resident IFMs are generally not subject to registration in other Canadian jurisdictions unless fund management activities are conducted on the ground in the local jurisdiction.

iii Derivatives regulation

Unlike the regulation of securities, the regulation of exchange-traded and over-the-counter (OTC) derivative instruments in Canada has not been harmonised, and the applicable rules and regulatory approaches vary considerably across all Canadian jurisdictions. Direct derivatives-related asset management activities in a separately managed account format and indirect activities through certain types of commingled vehicles are subject to the application of these rules in the Canadian jurisdiction in which a managed account client is located or the fund is managed. Depending on the jurisdiction, non-Canadian asset managers may rely on certain very limited regulatory exemptions, but may also be required to register

or seek discretionary relief to provide derivatives-related advice. The Canadian Securities Administrators (CSA) have published a series of consultation papers in connection with the implementation of G20 reforms relating to dealer and adviser registration and derivatives execution facilities. In addition, proposed rules have been published for comment on the central clearing of OTC derivatives, which would generally apply to direct clearing participants (and their affiliates) and major swap market participants, and on segregation and porting for customer collateral in cleared derivatives. In general, the CSA have expressed their intention to maintain consistency with the rule-making approaches in the United States and Europe, with necessary adjustments to accommodate the size and specificities of the Canadian OTC derivatives market.

The first area of actual rulemaking has been with respect to the recognition of trade repositories and derivatives data reporting. Ontario, Quebec and Manitoba each published final rules on trade repositories and derivatives data reporting that came into effect on 31 December 2013, subject to staggered implementation provisions with respect to derivatives data reporting. Canadian and non-Canadian banks that are active in the non-cleared Canadian OTC derivatives market as ‘derivatives dealers’ are expected to take the lead as ‘reporting counterparties’ under the data reporting rules. Clearing agencies and derivatives dealers generally began reporting as of 31 October 2014, while other OTC derivatives market participants began reporting on 30 June 2015, subject to a limited exception for inter-affiliate trades by end users.

Substantially harmonised rules in all of the other Canadian jurisdictions came into force between May 2016 and July 2016, with mandatory trade reporting beginning on 29 July 2016 for clearing agencies and derivatives dealers.

The International Swaps and Derivatives Association, Inc (ISDA) has developed, in consultation with industry participants in the ISDA Canada Working Group, a number of useful tools for buy-side participants, including asset managers, fund managers, and other non-dealer market participants or end users in the Canadian OTC derivatives markets. Notably, on 20 March 2015, ISDA published its ‘Canadian Transaction Reporting Party Requirements’, which outlines key regulatory requirements relating to the reporting of derivatives transaction data and the procedures developed by the derivatives industry to facilitate dealer and end-user compliance with the new rules. ISDA has also published a Canadian Representation Letter to facilitate the exchange of information between parties in assessing how reporting requirements apply to them.

iv Early warning, insider reporting and takeover bid requirements

Canadian and foreign asset managers are subject to reporting requirements governing significant Canadian or inter-listed equity positions under management. The acquisition of beneficial ownership of, or control or direction over, 10 per cent or more of any class of voting or equity securities of a reporting issuer in Canada (i.e., a Canadian public company) (or 5 per cent where the issuer is the subject of a current takeover bid or tender offer) is a significant event under Canadian securities laws, and triggers a number of reporting and other compliance obligations under Canadian early warning, insider reporting and, in certain cases, takeover bid rules.

v Other areas of regulation

In addition to the sector-specific regulation and tax rules described below, the management of assets of Canadian-resident investors may also be subject to detailed regulation in the areas of

trading (e.g., registration, best execution, short selling, institutional trade matching, insider trading), brokerage and soft dollars, privacy, anti-spam, unsolicited telecommunication rules and lobbying. Quebec's Charter of the French Language establishes French as the official language of the Province of Quebec, and imposes (absent an exemption) French-language requirements with respect to such matters as the language of contracts, business names and commercial advertising on entities doing business in Quebec. Canadian anti-money laundering and terrorist-financing legislation also applies to domestic and non-Canadian asset managers doing business in Canada, although the application of these rules in the context of cross-border asset management arrangements is an area of some difficulty.

III COMMON ASSET MANAGEMENT STRUCTURES

There is no prescribed structure for asset management vehicles in Canada. Funds may be organised as corporations, trusts or limited partnerships. The choice of structure is generally driven by the particular investment strategy of the fund, its target investor base and related tax considerations.

i Legal structures

Corporations

A fund may be organised as a corporation under either the Canadian federal business corporation statute or the corresponding statutes of any of the provinces or territories; the statutes are generally similar. A fund that is a corporation may utilise a multiple class structure, with each class of shares tracking a different portfolio of assets. Tax-deferred switches between classes are available. However, as part of the 2016 Federal Budget, the government proposed to eliminate the ability of shareholders of one corporate fund to switch to another corporate fund on a tax-deferred basis after September 2016.

Trusts

Many funds in Canada (e.g., retail mutual funds and pooled funds sold in the exempt market) are structured as mutual fund trusts, which are flow-through vehicles that are generally taxed at the highest marginal rate for individuals. However, a deduction is available in respect of income paid or payable to beneficiaries, making trusts generally efficient flow-through vehicles for investment income. To the extent that the trust incurs losses, they may not be allocated to unitholders.

A fund structured as a mutual fund trust is managed by an administrative arm, the trustee, which is independent from the beneficiaries. The management of the trust is subject to the rules applicable to the administration of the property of others. As is the case with respect to the directors of corporations, the trustees of a trust also have the power to name the officers of such trust.

Limited partnerships

A limited partnership is not a legal entity separate from its partners under Canadian law, meaning that the gains and losses of the private fund structured as such flow through to its limited partners. That said, limited partnerships may be treated as separate legal entities for certain purposes. For example, a limited partner may lend money to, and transact business with, the limited partnership. A limited partnership is required to have a general partner and at least one limited partner. A limited partner is not liable as a general partner unless, in

addition to exercising rights and powers as a limited partner, the limited partner takes part in the control of the business. Unlike the limited partnership legislation in some jurisdictions, the limited partnership statutes in Canada do not contain safe harbour provisions clearly delineating conduct that is not taking part in the control of the business of the partnership. Consequently, limited partnership agreements need to be drafted with particular care regarding this issue. Although the characterisation of limited partnerships under Quebec law (which is a civil law jurisdiction) is slightly different, Quebec limited partnerships are also flow-through vehicles and the applicable rules, as with the rules in other Canadian jurisdictions, present certain structuring benefits. Canadian (provincial) limited partnerships are increasingly used as an attractive structuring alternative to limited partnerships formed in certain traditional offshore jurisdictions.

ii Product structures

There are a number of collective investment vehicles in Canada that fall under the umbrella of investment funds. Under Canadian securities laws, an investment fund is generally defined as a mutual fund or a non-redeemable investment fund, being an issuer whose primary purpose is to invest money provided by its investors that does not invest for the purpose of exercising control of an issuer or for the purpose of being actively involved in the management of any issuer in which it invests. Whether a particular vehicle should be characterised as an investment fund has important securities regulatory implications (e.g., for IFM registration (discussed in Section II.ii, *supra*), post-trade reporting, regulatory fee payments in Ontario, financial reporting and fund governance). For Canadian securities law purposes, an investment fund is treated as distinct from a private equity fund that does invest for control or for the purpose of being actively involved in the management of the issuer in which it invests. Certain real estate, business income and royalty trust vehicles may also not be captured by the definition of investment fund.

Retail

Mutual funds are the conventional investment fund product for the retail market in Canada. A mutual fund under Canadian securities legislation is a fund whose primary purpose is to invest money provided by its investors, and the securities of which are redeemable on demand, or within a specified period after demand, by the investor at an amount computed with reference to the value of a proportionate interest in the whole or part of the net assets of the fund. Mutual funds generally issue an unlimited number of securities on a continuous basis. Conventional mutual funds are typically offered by prospectus to retail investors, and are governed by a number of specific rules that prescribe particular prospectus disclosure and set out, *inter alia*, requirements concerning permitted and prohibited investments, restrictions on leverage, short selling, and the use of derivatives and other investment practices, asset custody, conflicts of interest, security holder voting rights, incentive fees and sales commissions. Moreover, retail mutual funds are also subject to, *inter alia*, ongoing reporting requirements, including the annual publication, mailing to security holders and filing with the securities regulators of a simplified prospectus, annual information form, fund facts document (i.e., a prescribed summary of the material features of the fund), and annual and semi-annual financial statements.

Mutual funds are generally, although not exclusively, retail products. By contrast, non-redeemable investment funds typically issue securities with more limited redemption features by way of private placement or on an initial public offering (following which, in

the latter case, the securities are generally traded on an exchange at prevailing market prices, independent of the fund's net asset value). Non-redeemable investment funds, including hedge funds structured as such or flow-through limited partnerships, offered on a retail basis by prospectus, are subject to the general prospectus rule applicable to all types of issuers and are subject to requirements on custody, but not to other specific rules governing their permitted investments. Investment funds that are reporting issuers (a status that results from their offering by prospectus or being listed on an exchange in the local jurisdiction) are subject to rules concerning continuous disclosure and requirements for an independent review committee, being National Instrument 81-106 – Investment Fund Continuous Disclosure (NI 81-106) and National Instrument 81-107 – Independent Review Committee for Investment Funds. Reform initiatives in the form of an investment fund modernisation project initiated by the CSA are increasingly introducing a level playing field in this asset class that has been subject to many of the same rules applicable to mutual funds from September 2014. Investment funds offered by prospectus that are not mutual funds would typically be listed on an exchange in Canada. As with mutual funds, non-redeemable investment funds are offered both in the public sphere to retail investors, which requires the use of a prospectus, and privately on a prospectus-exempt basis to accredited investors.

Mutual funds may also be established as regulated commodity pools, which are not subject to the detailed investment restrictions governing conventional mutual funds in the areas of derivative instruments, short selling, and investments in precious metals and other excluded asset classes.

Mutual funds include not only traditional retail mutual funds but also exchange-traded mutual funds (ETFs), the securities of which trade on a stock exchange. In the case of ETFs, typically only large institutional investors (i.e., designated brokers) purchase or redeem ETF securities directly from the fund at the fund's net asset value, and then only in large blocks, which are usually exchanged in kind with baskets of the underlying securities. Individual retail investors typically buy and sell units of ETFs on the exchange at prevailing market prices, which may be at a premium or discount to a fund's net asset value.

Institutional

Leaving aside assets that are managed in-house (e.g., pension or insurance company assets), institutional investors in Canada typically invest through separately managed accounts with asset managers, in privately placed investment funds (e.g., hedge funds) structured with or without a redemption feature, and in private equity, real estate or infrastructure funds that may or may not be regulated as investment funds. Fund-of-one structures are also increasingly employed for large Canadian pension fund investors. Since, by virtue of their private placement, such products are intended for sophisticated investors, they are subject to few strictures as to investment restrictions, and limited or no ongoing investor disclosure requirements. The CSA have, however, signalled their intention to enhance their oversight of hedge funds and similar products sold in the exempt market in Canada.

IV MAIN SOURCES OF INVESTMENT

As at January 2014, there were C\$2.27 trillion of assets under management in Canada. This amount was composed of:

- a* C\$752 billion in pension segregated funds and pension pooled funds;

- b* C\$207 billion in investment assets of Canadian life insurance companies and corporate balance sheets;
- c* C\$66 billion of assets of endowments, foundations and trust funds;
- d* C\$593 billion of assets invested in mutual funds;
- e* C\$241 billion of sub-advised assets;
- f* C\$55 billion in insurance segregated funds; and
- g* C\$355 billion of other assets.²

V KEY TRENDS

As noted in Section II.ii, *supra*, the recent key initiative in the regulation of the asset management sector in Canada was the introduction of and ongoing revisions to NI 31-103, which sets out rules applicable across Canadian jurisdictions with respect to the registration of dealers, advisers and IFMs, and related exemptions from these requirements.

More recently, emerging Canadian regulatory initiatives are broadly focused on investor protection measures. First, various aspects of the Client Relationship Model, Phase 2 (known as CRM2), a set of regulatory initiatives requiring certain registrants to furnish their clients with greater disclosure about their investments, are in the process of being implemented. Second, Canadian securities regulators are examining Canada's current mutual fund fee structure to determine if there are investor protection issues that must be addressed, in particular with respect to sales and trailing commissions. Third, Canadian securities regulators are considering whether to impose a 'regulatory best interest standard' on advisers and dealers to act in the best interests of clients. Canadian securities regulators have published a consultation paper and have held and will continue to hold extensive consultations on the topic.

Deliberations on the implementation of these investor protection measures are complicated by the advent of robo-advisers, a type of automated online portfolio management service. Robo-advisers and related technological disruptions are a challenge for conventional investor protection regulations. At the moment, the onus is on Canadian securities regulators to adapt to recent advances in financial technology.

Apart from investor protection issues, there are two other notable emerging Canadian regulatory developments. The securities commissions in Ontario and Quebec recently launched their own whistle-blower programmes. Unlike the programme in Ontario, the Quebec programme will not offer financial incentives to whistle-blowers. The Quebec programme will instead rely on whistle-blower protections, such as immunity from civil lawsuits, to encourage individuals to report. In addition, Canadian securities regulators are developing regulation, including investment restrictions, to govern 'alternative funds' being publicly offered investment funds that invest in assets or use investment strategies that are not permitted under existing investment fund regulations.

Outside the regulatory sphere, a notable trend that has been developing over the past few years has been the increased internalisation of the asset management function by some of Canada's large public sector pension funds. Large Canadian pension fund managers,

2 These data were obtained from the 2015 Canadian Responsible Investment Trends Report published by the Responsible Investment Association, which in turn sourced the data from the Canadian Institutional Investment Network.

such as the Canada Pension Plan Investment Board, which manages the pension assets of 18 million Canadians (C\$278.9 billion in assets under management as at 31 March 2016), the Ontario Teachers Pension Plan, which manages the pension assets of Ontario's teachers (C\$171.4 billion in assets under management as at 31 December 2015) and the Caisse de dépôt et placement du Québec, which as at 31 December 2015 managed C\$248.0 billion on behalf of public and private pension and insurance funds in Quebec, have each shifted a large portion of their portfolios away from third-party asset managers and increased their direct investment activities.

Canadian public and private sector pension plans continue to invest in various asset classes both in and outside Canada. A notable trend has been to make such investments through fund-of-one vehicles with negotiated reporting and liquidity provisions. The use of foreign segregated portfolio company vehicles and other structured transparency platforms is also developing.

VI SECTORAL REGULATION

i Insurance

Canadian federally incorporated insurance companies are regulated as to solvency matters under the Insurance Companies Act (Canada) (ICA) by the federal Office of the Superintendent of Financial Institutions, which is the prudential regulator for all federally regulated financial institutions in Canada.

The ICA provides a number of detailed rules regarding the investments permitted to be made by federally incorporated insurance companies. The general constraint on investments by federally incorporated insurance companies under the ICA is that the directors 'must establish and the company must adhere to investment and lending policies, standards and procedures that a reasonably prudent person would apply in respect of a portfolio of investments and loans to avoid undue risk of loss and obtain a reasonable return'. This provides significant investment discretion and is a move away from the pre-1992 version of the ICA, which contained very specific investment standards for permissible investments and loans by insurance companies. Federally incorporated insurance companies are also generally prohibited under the ICA from acquiring control of, or holding, acquiring or increasing a substantial investment in, any entity other than a permitted entity as described under the ICA. The ICA also contains a number of rules regulating investment by federally incorporated insurance companies in related parties.

ii Pensions

Registered pension plans must be registered under the particular federal or provincial minimum standards legislation to which the pension plan is subject and under the Income Tax Act (Canada) (Tax Act). The federal Pension Benefit Standards Act, 1985 (PBSA) and corresponding provincial legislation impose on the plan administrator various fiduciary obligations, including the requirement to invest pension plan assets in accordance with the standard of care applicable to a person of ordinary prudence dealing with the property of another person. In addition, certain statutes (including, in particular, the PBSA and the Quebec Supplemental Pension Plans Act (SPPA)) impose an express portfolio management theory standard on those responsible for investing pension plan assets.

The legislation authorises a pension plan administrator to employ agents in the administration and investment of the pension fund. In some cases (such as the SPPA), this

authorisation is explicit; in others (such as the PBSA), it is only implicit. These persons then become subject to the standard of care that applies to the pension plan administrator, as described above.

A pension plan administrator must establish a written statement of investment policies and procedures (SIP&P) that meets the requirements of the legislation to which it is subject. As a matter of agreement between the administrator and an external investment manager, the manager will usually be required to ensure that pension fund investments comply with the SIP&P as provided to the manager. The investment manager would normally not be responsible for verifying that the contents of the SIP&P comply with applicable legislation.

The Provinces of Alberta, British Columbia, Manitoba, Ontario and Saskatchewan have formally adopted by reference the investment rules contained in Schedule III to the Regulations under the PBSA, and the Provinces of Nova Scotia, and Newfoundland and Labrador have established their own rules that are substantially similar to the rules contained in Schedule III. While the Provinces of New Brunswick and Quebec have each enacted pension fund investment rules that differ in some respects (particularly in the case of Quebec) from Schedule III, it is fair to say that there is substantial, but not perfect, harmonisation of pension fund investment rules in Canada.

Schedule III contains detailed and complex rules regarding related-party transactions, as well as qualitative and quantitative investment restrictions that are generally applicable on a plan-by-plan basis (e.g., no more than 10 per cent of the total value of a plan's assets measured on a book or market value, depending on the jurisdiction, may be invested, directly or indirectly, in any one person, two or more associated persons, or two or more affiliated corporations). As a result, in addition to compliance with the limit itself, the administrator will generally demand exact and timely reporting from all external investment managers so that it may aggregate such information at the plan level.

Schedule III applies both to direct and indirect investments of a pension plan. Their application to indirect investments may give rise in some cases to certain complexities.

Investments of registered pension plans in Canada must also comply with the investment rules contained in the Tax Act and its Regulations or face deregistration, with adverse tax consequences for plan participants and the plan sponsor.

The Tax Act Regulations impose certain investment rules for pension plans. For example, investments in shares or debt of an employer are prohibited, unless the shares of the employer are listed on a prescribed stock exchange. The Tax Act Regulations also contain restrictions on borrowing and the giving of security over property held in connection with the pension plan. The Tax Act also contains rules governing real estate, resource property and passive investments of certain corporations owned by pension plans.

It should be noted that certain statutory pension plans, such as the Canada Pension Plan, have their own governing rules, many of which are similar but not identical to the rules outlined above.

iii Real property

There are no regulations specific to funds that invest in real estate. Depending on how they are structured, such funds may not be regulated as investment funds subject to the adviser and IFM registration requirements noted in Section II.ii, *supra*. However, the sale of securities of such funds are subject to the prospectus requirement – unless privately placed – and the dealer registration requirement. It should be noted that there is a robust publicly traded real

estate investment trust (REIT) sector in Canada designed to allow retail investors to have an interest in a diversified package of income-producing real estate with cash flow distributed to unitholders.

iv Hedge funds

There is no definition of hedge fund in Canadian securities legislation. CSA staff have referred to them broadly as investment pools that use alternative investment strategies not generally available to traditional mutual funds such as taking both long and short positions, and using arbitrage, leverage, options, futures, bonds and other financial instruments to capitalise on market conditions. A hedge fund would be an investment fund, and could fall under the mutual fund branch of that definition if structured with a redemption feature that meets the requirements for mutual fund status.

Most hedge funds are sold in Canada by private placement. There are no specific rules that apply to hedge funds sold on a private placement basis that regulate their investment activities or how they operate, although a privately placed hedge fund that is organised under the laws of certain provinces, including the Province of Ontario, and is structured as a mutual fund (i.e., redeemable on demand, or within a specified period after demand), is required to provide investors with continuous disclosure under certain parts of NI 81-106.

Persons or companies involved in the management of hedge funds, the provision of portfolio management services to hedge funds and the offering of hedge fund securities to investors in Canada are subject to IFM, adviser and dealer registration requirements, as noted in Section II.ii, *supra*.

v Private equity

As with funds that invest in real property, there are no regulations specific to private equity funds. Under Canadian securities laws, the term 'private equity fund' refers to a fund that invests for the purpose of exercising control of an issuer or for the purpose of being actively involved in the management of an issuer in which it invests. The control or active management exerted by the private equity fund in portfolio companies is what sets it apart from an investment fund and, as a result, relieves the fund of the adviser and IFM registration requirements noted in Section II.ii, *supra*. The offering of private equity securities in Canada is subject to the prospectus requirement – although there are few retail private equity funds, as most private equity funds privately place their securities with accredited investors – and the dealer registration requirement.

vi Alternative Investment Fund Managers Directive (AIFMD)

In July 2013, the four lead securities regulators in the Canadian market entered into memoranda of understanding with financial regulators in a number of European Union and European Economic Area Member States for the supervision of alternative investment fund managers as required under the AIFMD, which entered into force on 22 July 2013. These memoranda of understanding were entered into by the Canadian regulators in anticipation of the fact that the AIFMD will directly affect both Canadian managers that manage funds in the EU and Canadian funds marketed in the EU by Canadian or EU-based fund managers. Significantly, the AIFMD effectively regulates a much broader array of fund structures than conventional alternative investment funds, and covers hedge funds, private equity funds, venture capital funds, real estate funds, commodity funds, investment trusts

and other collective investment vehicles. As a result, managers of funds that are not regulated as investment funds and are not subject to registration under Canadian securities laws may be subject to the application of AIFMD in connection with their European activities.

vii Other asset classes

Royalty-based funds and hybrid funds with separate private equity and traded portfolio sleeves or liquid side pockets have also developed in the exempt market in Canada. These vehicles are generally subject to the rules governing conventional investment funds, although, depending on the degree of active management and the manner in which portfolio assets are structured, certain types of royalty-based funds may be viewed as functionally analogous to private equity funds or royalty trusts and would not be captured by the definition of investment funds.

VII TAX LAW

The tax treatment of a fund in Canada is primarily determined by its characterisation as a partnership, mutual fund trust or mutual fund corporation (note that the term ‘mutual fund’ is separately defined under the Tax Act, and is not meant to delineate between investment funds structured as open-ended mutual funds and entities structured as non-redeemable investment funds).

i Limited partnerships

A limited partnership itself is generally not liable for income tax; nor is it required to file income tax returns, except in some cases for annual information returns. A limited partnership must compute its income (or loss) under the Tax Act for each of its fiscal periods as if it were a separate person resident in Canada. As a limited partnership, all income, capital gains, losses and capital losses of the private fund would, subject to certain exceptions, flow through to its investors. However, a specified investment flow-through (SIFT) partnership is effectively taxed as a corporation on its non-portfolio income (see the discussion regarding the SIFT rules below).

Subject to the at-risk rules discussed below, each partner of a partnership is required to include (or is entitled to deduct), when computing the partner’s Canadian income for a taxation year, the partner’s *pro rata* share of the income (or loss) of the partnership allocated to such partner for the fiscal period of the partnership ending in or at the end of the partner’s taxation year. This is the case regardless of whether distributions were actually made by the limited partnership. The Tax Act also contains at-risk rules that may, in certain circumstances, limit the ability of a limited partner to deduct its share of the limited partnership’s losses for a taxation year to the amount the partner has put at risk.

A disposition of an investment in a Canadian limited partnership, a mutual fund trust or a share of a mutual fund corporation (as described below) by a non-resident of Canada for the purposes of the Tax Act will generally not be subject to Canadian tax unless the investment is taxable Canadian property for the purposes of the Tax Act, and the gain is not exempt from Canadian tax by an applicable income tax treaty or convention.

Generally, limited partnership interests, units of mutual fund trusts or shares of mutual fund corporations will not be taxable Canadian property at any time, unless at any

time within the five previous years more than half of the fair market value of the partnership's property was attributable to real or immoveable property in Canada or certain Canadian resource properties.

A disposition of limited partnership interests, mutual fund trust units or shares of mutual fund corporations by a Canadian-resident investor who holds such investment as capital property will generally result in a capital gain (or loss) to such investor.

ii Trusts

A fund structured as a mutual fund trust will generally not be liable for income tax in respect of its income and net realised capital gains for a taxation year to the extent that it distributes such income and net realised capital gains to its beneficiaries. To qualify, a mutual fund trust must meet certain conditions, including that it must comply with certain prescribed conditions, including those relating to the number of its unitholders.

Provided that certain conditions are met, a mutual fund trust may designate a portion of its foreign-source income to its unitholders so that such income and a portion of the foreign tax paid by the trust may be regarded as foreign-source income of, and foreign tax paid by, the unitholder for the purposes of the foreign tax credit provisions of the Tax Act. Generally, when a mutual fund trust designates certain amounts to its unitholders, including, but not limited to, dividends received and foreign-source income, these designated amounts will retain their character in the hands of its unitholders.

The Tax Act treats non-portfolio income of a SIFT trust or partnership as if the income had been earned through a taxable Canadian corporation. Under the SIFT rules, tax is imposed at the trust or partnership level at the corporate tax rates, and investors are deemed to have received dividends from taxable Canadian corporations. Income that is subject to this tax is generally income from carrying on a business in Canada, Canadian real or immoveable property, or investments in subject entities in excess of certain thresholds.

Investors in a mutual fund trust are required to include in their income, for tax purposes, the amount of net income and net realised taxable capital gains paid or payable to them by the trust and deducted by the trust in computing its income for tax purposes. Generally, to the extent that distributions to an investor by the trust exceed the investor's share of the net income and net realised capital gains of the trust for the year, such excess distributions (except to the extent that they are proceeds of disposition of a unit) will not be taxable in the hands of the investor but will reduce the adjusted cost base of an investor's units of the trust. To the extent that the adjusted cost base of a unit would be negative, the negative amount would be deemed to be a capital gain realised by the investor in the year, and the adjusted cost base of such unit will be increased by the amount of such deemed capital gain.

The Tax Act contains rules for Canadian residents holding non-controlling interests in non-resident entities owning primarily passive investments. The existing rules apply where a taxpayer has invested in offshore investment fund property, and one of the main reasons for the investment is to reduce or defer the tax that would have arisen had the income from the assets of the fund been earned directly. Where these rules apply, income is calculated based on the taxpayer's cost amount multiplied by a prescribed interest rate. These rules should only apply to Canadian-resident beneficiaries of non-resident commercial trusts.

iii Corporations

A corporation is a separate legal entity for tax purposes. Corporations are generally not an efficient vehicle for the flow-through of ordinary income. However, a mutual fund

corporation is tax-efficient with respect to taxable dividends earned on shares of taxable Canadian corporations because it is able to deduct those dividends from its income and receive a refund of tax that it pays on those dividends upon paying taxable dividends out to its shareholders. In addition, taxes paid by the mutual fund corporation on realised capital gains will be refundable on a formula basis when shares are redeemed or when the fund pays capital gains dividends. As a result, capital gains dividends are taxed as capital gains in the hands of the shareholders. To qualify as a mutual fund corporation, a corporation must meet the following conditions:

- a* it must be a Canadian corporation;
- b* it must have shares that are redeemable at the demand of the holder, and such shares must represent at least 95 per cent of the fair market value of all of the corporation's issued shares;
- c* its only undertaking must be the investing of its funds in property; and
- d* it must be a public corporation.

Taxable dividends and eligible dividends paid by a corporate fund, other than capital gains dividends, must be included in computing an investor's income. The dividend gross-up and tax credit treatment normally applicable to taxable dividends and eligible dividends paid by a taxable Canadian corporation will apply to such dividends in the case of an investor who is an individual. Returns of capital distributions are not included in income, but reduce the adjusted cost base of the investor's shares.

VIII OUTLOOK

The Canadian economy has weathered the post-2008 global economic crisis comparatively well owing in part to a robust and highly capitalised domestic banking sector, and to relatively strong energy, mining and resource sectors. The European debt crisis, weak recovery in the United States and slower growth in emerging markets have boosted demand for Canadian assets, but have also heightened Canada's exposure to global economic challenges. Despite a strong showing in the aftermath of the global economic crisis, Canadian energy, mining and resource companies have fallen out of favour and the Canadian housing sector is the subject of increasing scepticism. In the asset management space, poor performance in equity markets and falling asset values have produced a shift in retail investment to fixed income, low-cost ETF and money market products, and a trend away from commission-based passive investment products in favour of the fee-based advice model. Manufacturers of asset management products continue to develop target date and other life cycle products tailored to the baby-boomer retirement market. In the institutional market, pension funds and other institutional investors continue to seek out returns through investments in infrastructure, real estate investment vehicles and other alternative asset classes.

On the regulatory front, as in other countries, Canadian regulators have embarked on a comprehensive reform of OTC derivatives markets, leaving the byzantine regulatory framework governing exchange-traded derivatives in Canada largely untouched. The CSA have launched an investment fund modernisation project to adjust Canadian mutual fund rules to global standards in mutual fund product regulation (including in the area of money market funds), address any market efficiency, investor protection or fairness issues that arise out of the differing regulatory regimes that apply to different types of publicly offered investment funds, and reduce the perceived potential for regulatory arbitrage.

To date, Canada has not followed initiatives in the United Kingdom, Europe and Australia to ban or restrict the payment of trailing and other commissions for product recommendations, although fees charged by mutual fund managers, and their level of transparency, have been a particular focus of the CSA. Regulatory initiatives in Canada have, however, focused on implementing the client relationship model, with detailed requirements to enhance point-of-sale disclosure, product fee and cost transparency, know-your-client and suitability assessments, and performance and account reporting. As in other countries, Canadian regulators continue to ponder the introduction of a common fiduciary standard for all financial advisers, making initial proposals in this regard, and have stepped up market surveillance, routine compliance sweeps and on-site regulatory audits. On the whole, and barring any catastrophic developments, the outlook for the asset management sector and the related regulatory environment in Canada is expected to remain comparatively stable.

Appendix 1

ABOUT THE AUTHORS

ALIX D'ANGLEJAN-CHATILLON

Stikeman Elliott LLP

Alix d'Anglejan-Chatillon is a partner at Stikeman Elliott LLP in its Montreal office and co-head of the firm's financial products and services group. She practises principally in the areas of investment management, the regulation of capital markets and derivatives. Her clients include managers of North American, European and Asian-based investment funds, including private equity funds, hedge funds, venture capital funds, mutual funds and fund of funds, as well as other asset managers, broker-dealers, and commercial and investment banks. She also represents institutional, family office and high-net-worth investors in connection with their investments in various investment fund structures. She is a graduate of Queen's University (BA, 1984) and the McGill University School of Law (LLB, 1987 and BCL, 1988). She was called to the Quebec and Paris Bars in 1989 and 1994, respectively.

JEFFREY ELLIOTT

Stikeman Elliott LLP

Jeffrey Elliott is a partner at Stikeman Elliott LLP in its Toronto office. His practice primarily focuses on securities law with an emphasis on investment funds. Mr Elliott acts for a broad range of financial institutions as well as investment fund managers, domestic and international dealers and advisers, and public and private investment funds. In addition, he has significant experience with mergers and acquisitions and public financings. Mr Elliott received his BA with honours from McMaster University in 1997 and obtained an LLB from Osgoode Hall Law School in 2000. He was called to the Ontario Bar in 2002.

STIKEMAN ELLIOTT LLP

1155 René-Lévesque Boulevard West, 41st Floor
Montreal
Quebec H3B 3V2
Canada
Tel: +1 514 397 3000
Fax: +1 514 397 3222

5300 Commerce Court West
199 Bay Street
Toronto
Ontario M5L 1B9
Canada
Tel: +1 416 869 5500
Fax: +1 416 947 0866

adanglejan@stikeman.com
jelliott@stikeman.com
www.stikeman.com