THE PRIVATE EQUITY REVIEW

NINTH EDITION

Editor
Stephen L Ritchie

THE LAWREVIEWS

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PREFACE

The ninth edition of *The Private Equity Review* follows another extremely active year for dealmakers in 2019. While the number and value of global private equity deals completed declined slightly from 2018, deal activity was still robust, weighted towards the upper end of the market, and included several large take-private transactions. Fundraising activity was also strong with aggregate capital raised just slightly below 2018's record levels, as institutional investors remained extremely interested in private equity as an asset class because of its continued strong performance. That, combined with some caution due to an uncertain market environment, has resulted in private equity funds having significant amounts of available capital, or dry powder. This dry powder, together with competition from non-traditional dealmakers, such as sovereign wealth funds, family offices and pension funds, led to very competitive transactions being completed at increasing purchase price multiples. This has caused private equity firms to become even more creative as they seek opportunities in less competitive markets or in industries where they have unique expertise. Given private equity funds' dry powder and creativity, we expect private equity will continue to play an important role in global financial markets, not only in North America and western Europe, but also in developing and emerging markets in Asia, South America, the Middle East and Africa. In addition, we expect the trend of incumbent private equity firms and new players expanding into new and less established geographical markets to continue.

While there are potential headwinds – including trade tensions, the upcoming US election and an eventual end to one of the longest-running recoveries in US history – on the horizon for 2020 and beyond, we are confident that private equity will continue to play an important role in the global economy, and is likely to further expand its reach and influence.

Private equity professionals need practical and informed guidance from local practitioners about how to raise money and close deals in multiple jurisdictions. *The Private Equity Review* has been prepared with this need in mind. It contains contributions from leading private equity practitioners in 22 different countries, with observations and advice on private equity dealmaking and fundraising in their respective jurisdictions.

As private equity has grown, it has also faced increasing regulatory scrutiny throughout the world. Adding to this complexity, regulation of private equity is not uniform from country to country. As a result, the following chapters also include a brief discussion of these various regulatory regimes.

I want to thank everyone who contributed their time and labour to making this ninth edition of *The Private Equity Review* possible. Each of these contributors is a leader in their respective markets, so I appreciate that they have used their valuable and scarce time to share their expertise.

Stephen L Ritchie
Kirkland & Ellis LLP
Chicago, Illinois
March 2020

Part I

Fundraising

Chapter 3

CANADA

Jonathan Halwagi, Tracy Hooey, Anabel Quessy and Ryan Rabinovitch[1]

I GENERAL OVERVIEW[2]

After the historical heights that fundraising activity in Canada reached in 2017,[3] the Canadian private equity market experienced a significant slowdown in fundraising in 2018, with industry reports indicating a potential resetting of the fundraising cycle.[4]

While industry reports are not yet available for the Canadian private equity market for 2019, we observe a few notable fundraisings, such as the Canadian firm Brookfield Asset Management Inc closing its fifth flagship private equity fund with total equity commitments of C$9 billion in November 2019.[5] With its private equity division run out of New York, the launch of this fund tipped US private equity fundraising to an all-time high.[6] Also noteworthy was the closing of Altas Partners Holdings II LP, oversubscribed at its hard cap of C$3 billion, also in November 2019.[7]

The government of Canada continues to support the venture capital industry by contributing to its continued growth.[8] In 2018, the government of Canada, through the Business Development Bank of Canada, started implementing the Venture Capital Catalyst Initiative (VCCI), which aims to invest C$450 million in large private sector-led funds-of-funds and in venture capital fund managers to increase the availability of late-stage venture

1 Jonathan Halwagi, Tracy Hooey, Anabel Quessy and Ryan Rabinovitch are partners at Fasken Martineau DuMoulin LLP.

2 This section is based on industry reports available in January 2020. Private equity or venture capital firms in Canada are not required to report their activities; consequently, the industry reports reflect verifiable information only and may not adequately reflect the activities of all private equity or venture capital firms.

3 PitchBook Data Inc, *Canadian PE & VC FactBook, 1H 2018*, available at https://pitchbook.com/news/reports/1h-2018-canadian-pe-vc-factbook (PitchBook Report 1H 2018).

4 PitchBook Data Inc, *Canadian PE & VC FactBook, 2018 Annual*, available at https://files.pitchbook.com/website/files/pdf/PitchBook_2018_Annual_Canadian_PE_VC_FactBook.pdf (PitchBook Report Annual 2018).

5 Brookfield Asset Management Inc, 4 November 2019, 'Brookfield Closes US$9 Billion Global Private Equity Fund', *GlobeNewswire*, available at www.globenewswire.com/news-release/2019/11/04/1940203/0/en/Brookfield-Closes-US-9-Billion-Global-Private-Equity-Fund.html.

6 Haverstock, E, 6 November 2019, 'Private equity fundraising in the US hits all-time high'. PitchBook, available at https://pitchbook.com/news/articles/private-equity-fundraising-in-the-us-hits-all-time-high.

7 Cooper, L and Cumming, C, 4 November 2019, 'Altas Partners Raises $3 Billion for Second Longer-Life Fund', *Wall Street Journal*, available at www.wsj.com/articles/altas-partners-raises-3-billion-for-second-longer-life-fund-11572868800.

8 Canadian Venture Capital and Private Equity Association, Press Release, 'Government Of Canada Commits To Bolstering Canadian Innovation Through VCCI', 18 December 2018, available at www.cvca.ca/wp-content/uploads/2017/12/CVCA-VCCI-Press-Release-Dec-18-2017.pdf.

capital in Canada.[9] With funds from the private sector, this investment has the potential to inject around C$1.5 billion into Canada's innovation capital market.[10] Through the VCCI programme, 15 emerging and diverse managers were selected during 2018 and 2019, and eight venture capital funds have been launched in relation to this initiative.[11]

II LEGAL FRAMEWORK FOR FUNDRAISING

Common legal structure and key terms

Legal vehicle

As with most other jurisdictions, the selection of the legal structure for private equity funds is driven by tax considerations and liability protection for investors. The most common legal structure used for private equity funds in Canada is the limited partnership as it provides tax transparency (as discussed in Section III.ii) and limited liability to investors.

In Canada, limited partnerships can be established pursuant to the laws applicable in any of Canada's provinces and territories. The legal regime applicable to limited partnerships is generally similar across all Canadian jurisdictions, providing limited liability to investors who do not take an active part in the business of the limited partnership and providing a flow-through tax treatment to its partners.

Each Canadian jurisdiction expresses the concept of not taking an active part in the business of the partnership slightly differently. In Ontario, the Limited Partnership Act (Ontario) provides that a limited partner is not liable as a general partner unless the limited partner 'takes part in the control of the business'.[12] In Manitoba, the Canadian jurisdiction that is generally viewed as offering the widest protection to limited partners, the Partnership Act (Manitoba) provides that the loss of limited liability by a limited partner is caused by the limited partner taking 'an active part in the business of the partnership'.[13] However, unlike other Canadian jurisdictions, the limited liability of the limited partner is not lost with regard to any person who knew that the investor was a limited partner.[14]

Notwithstanding the above, private equity managers typically establish the fund under the laws of the province where they are established and conduct most of their activities. However, other considerations or pressures may come into play when deciding where to establish the fund in Canada. Key anchor investors may pressure the private equity managers to establish the fund in a jurisdiction they are more familiar with[15] or that provides slightly more advantageous language with regard to the limited liability of investors (such as Manitoba, for example, as described above).

9 Government of Canada, Venture Capital Catalyst Initiative, 6 November 2019, available at www.ic.gc.ca/eic/site/061.nsf/eng/h_03052.html.

10 ibid.

11 ibid.

12 See Section 13(1) of the Limited Partnership Act (Ontario), R.S.O. 1990, c. L.16.

13 See Sections 63(1) and 63(2) of the Partnership Act (Manitoba), C.C.S.M., c. P30.

14 ibid.

15 While there is often no specific tax advantage to doing so, when marketing to non-Canadian investors, Canadian private equity managers sometimes choose to establish their funds in offshore jurisdictions that are more familiar to the non-Canadian investors (e.g., the Cayman Islands).

Constituting document

The constituting document used to govern a limited partnership is the limited partnership agreement. The limited partnership agreement provides the terms of the fund, including the fund's investment objectives and restrictions, the duties and powers of the general partner and the limited partners, the capital call and distribution mechanisms and the fund's term, termination and liquidation.

While the specific terms of Canadian private equity funds can vary, the terms of larger funds are usually aligned with the prevailing market practice for similar funds established in larger jurisdictions (especially the United States and the United Kingdom). We discuss some of the key terms below.

Life of the fund

Private equity funds in Canada are traditionally established as closed-ended funds. The limited partnership agreement usually provides for an offering period of 12 to 18 months from the initial closing of the fund during which new or existing investors can make new capital commitments to the fund. After the offering period has ended, the fund is no longer open to new capital commitments.

The fund's life is divided into two phases – the investment period and the management period. During the investment period, which usually ranges from three to five years from the initial closing of the fund, the private equity manager deploys the capital committed by the limited partners by making portfolio investments. Thereafter, during the management period, subject to exceptions, the fund is generally not permitted to make further capital calls for investment purposes. During the management period, the general partner manages the portfolio investments, eventually finding exit opportunities to liquidate the portfolio. The management period usually ranges between four and seven years from the end of the investment period.

A recent trend has seen the establishment of evergreen private equity funds. Unlike the traditional closed-ended funds, evergreen funds do not have a pre-established fund life and are able to raise additional capital commitments on an ongoing basis.

Investment policy, investment restrictions

The fund's investment objectives, investment strategy and investment restrictions are often detailed in the limited partnership agreement or in one of its schedules.

Common restrictions often include limits regarding the jurisdictions in which investments can be made in, the maximum and minimum size of an investment, the amount of permitted indebtedness and restrictions related to the use of derivatives.

Governance

In terms of governance, Canadian private equity funds usually provide for the establishment of an advisory committee. Typically, limited partners having made capital commitments beyond an established threshold are given the right to appoint members of the advisory committee. At a minimum, the limited partnership agreement usually requires that the advisory committee review any proposed related-party transactions and provide guidance on other issues brought to it by the general partner.

Some Canadian private equity funds also provide a right to limited partners to remove and replace the general partner. While general partner removal provisions are not uncommon, their specific terms are by no means standard as they are heavily negotiated.

Management fees

Management fees are usually paid to the general partner (or the asset manager appointed by the general partner) in consideration for its management services. Management fees generally range from 1 per cent to 2 per cent of the aggregate commitments during the investment period and from 1 per cent to 2 per cent of the acquisition cost of portfolio investments after the investment period.

Organisational and offering expenses, operating expenses and general partner expenses

The limited partnership agreement also sets out who is responsible for assuming the various expenses incurred by the fund or by the general partner on behalf of the fund. These are often separated into three categories – organisational expenses, operating expenses and general partner expenses.

Organisational and offering expenses cover the establishment and organisation of the fund and the offering, sale and issuance of the interests of the fund. These expenses may include travel and accommodation expenses, and any expenses incurred in connection with the preparation of offering documents (including legal, accounting and filing fees). These expenses are generally borne by the fund up to a cap set by the limited partnership agreement. As a rule of thumb, the cap is usually set at not more than 1 per cent of aggregate commitments to the fund. Any organisational and offering expenses incurred above this cap are borne by the general partner.

Operating expenses cover, notably, all administration costs and expenses (e.g., legal, auditing, consulting, accounting, reporting, bookkeeping, financial, tax, insurance, valuation, contractor and custodial), expenses arising out of the contemplated or realised acquisition, holding, or sale of portfolio investments, and all extraordinary expenses, such as expenses relating to dispute resolution or damages. These expenses are also generally borne by the fund.

General partner expenses, which are commonly borne by the general partner, cover all expenses incurred for the operation and affairs of the general partner (e.g., costs of salaries, rent, fees incurred to promote the fund and to participate in networking events and other fees of the general partner that are not related to the fund).

Carried interest distributions

In addition to the management fees, the general partner (or an entity determined by the general partner) is usually entitled to receive carried interest distributions if distributions made to limited partners exceed their invested capital plus a preferred return (which typically ranges between 5 and 8 per cent). The carried interest distribution usually ranges between 15 and 20 per cent of distributions made beyond the preferred return threshold.

Standard of care

Most of the Canadian jurisdictions do not provide for a statutory standard of care for the general partner in their partnership laws. As such, many partnership agreements include a specific provision providing that the general partner discharge its duties diligently, in good faith and in the best interest of the fund.

Other key documents

Subscription agreement

Investors typically become limited partners by entering into a subscription agreement that sets out the amount of capital the investor is committing for investment in the fund, which is drawn down over time. The subscription agreement also contains representations, warranties and acknowledgements of the investor, notably relating to the accredited investor private placement exemption, residence and tax status of the investor. Investors that are individuals may be required to complete additional documents or will have a specific subscription agreement.

Management agreement

The general partner may delegate its powers to a manager either directly in the limited partnership agreement or in a separate management agreement. The management agreement typically addresses the powers being delegated to the manager, the management fees or other incentive consideration, including carried interest, and indemnification of the manager by the fund.

Marketing documents

One or more of the following documents is usually used to market a private equity fund in Canada – the offering memorandum, the term sheet and the marketing presentation.

The offering memorandum[16] is a marketing document purporting to describe the business and affairs of a fund that is prepared primarily for delivery to and review by prospective investors so as to assist them in making an investment decision in respect of an investment in the fund. It generally includes a description of the offering, the key terms of the fund (including its investment objectives, strategies and restrictions), a description of the business case supporting the fund's strategy and the risks associated with an investment in the fund. The laws of some of the Canadian jurisdictions provide statutory rights of rescission or damages, or both, to investors if an offering memorandum or one of its amendments contains a misrepresentation, provided these remedies are exercised within the time limits prescribed in each jurisdiction. These laws also generally require that the offering memorandum contain a description of these rights.

The term sheet is a summary of the key legal terms of the fund. A full version of the term sheet is normally included in the offering memorandum, but the term sheet can be used as a stand-alone marketing document, especially if an offering memorandum is not prepared in connection with the distribution of the fund. In some Canadian jurisdictions, term sheets or marketing presentations may be considered 'offering memoranda' and as such, may be subject to the statutory rights of rescission described above, including the requirement to include a description of these rights.

Side letters

It is not uncommon for private equity fund managers to provide certain investors with certain rights or preferential treatment by entering into side letter agreements with the investors. The provisions of such side letters alter the terms of the limited partnership agreement between

16 Offering memorandums are also commonly referred to as private placement memorandums and confidential information memorandum.

the investors and the general partner. As the side letter is not enforceable against the other limited partners, to be included in a side letter, the provision must not affect the other investors. Examples of rights that are often included in side letters include lower management fees, advisory committee membership, co-investment rights, specific disclosure rights, excuse or exclusion rights from fund investments and most favoured nation provisions.

III REGULATORY DEVELOPMENTS

i Regulatory requirements

From a regulatory perspective, there are two aspects that are important to consider when establishing and distributing private equity funds in Canada – the prospectus requirement and the registration requirements.

The prospectus requirement

In Canada, the issuance of interests in a private equity fund, whether the interests are unitised or not, is considered a distribution of securities.

The securities laws applicable in the Canadian jurisdictions prohibit the distribution of securities unless a prospectus has been filed and receipted by the applicable securities regulatory authority or the fund is otherwise exempt from this prospectus requirement.

The most common exemption from this requirement used by private equity funds is the private issuer exemption. Pursuant to the private issuer exemption, the prospectus requirement does not apply to a distribution of a security of a private issuer if the distribution of securities is made to an investor who subscribes to the security as a principal and is an accredited investor.

A closed-ended private equity fund will generally be considered a private issuer as long as it invests for the purpose of being actively involved in the management of the portfolio entities in which it invests, has restrictions on the transfer of its securities and as long as its securities are held by no more than 50 persons.

Accredited investors are investors that have the required sophistication to understand the risks relating to their investment and can financially bear the risk of losses relating to their investment. The list of accredited investors includes financial institutions, pension funds, government entities, trust companies, investment funds or accounts managed by registered advisers and high-net-worth persons.

Canadian regulatory authorities require that the fund take some steps to confirm the investor can rely on this prospectus exemption.

To the extent that the private issuer exemption is not available for use, the fund may rely on other available exemptions, including one for issuance of securities to accredited investors generally. This requires the filing of a report of an exempt trade.

The registration requirements

Canadian securities laws require that a person not engage in the business of trading in securities unless that person is registered as a dealer; not engage in the business of providing advice with respect to investing in securities unless that person is registered as an adviser; and not act as an investment fund manager unless the person is registered as an investment fund manager.

With regard to private equity funds, the Canadian regulatory authorities have issued guidance that provides that a typical closed-ended private equity fund, its general partner and

its asset manager would generally not be required to register as dealers, advisers or investment fund managers as long as (1) the advice provided by the general partner (or the asset manager) in connection with the purchase and sale of portfolio entities is incidental to their active management of these portfolio entities; (2) both the raising of money from investors and the investing of that money by the fund are occasional and uncompensated; and (3) the fund invests for the purpose of being actively involved in the management of the portfolio entities in which it invests. Examples of active management in a portfolio entity include the general partner (or the asset manager) having representation on the board of directors or a say in material management decisions.

Most Canadian private equity funds fit within the scope of this guidance and, as such, are not investment funds for securities law purposes and are not required to be registered to conduct their activities.

ii Canadian taxation overview

Because private equity funds are typically structured as limited partnerships in Canada, the following is a general overview of the tax implications of such a structure for the funds and its investors.

Fund and Canadian investors

Limited partnerships are generally not subject to Canadian federal income tax. Rather, the general partner calculates the limited partnership's income and losses for each fiscal period and allocates them to the partners. The partners are then required to report their share of income or losses on their income tax returns. Particular sources of income and losses of the limited partnership, including capital gains and capital losses, retain their character when allocated to the partners. Consequently, the limited partnership is transparent for tax purposes and its partners are treated as though they had incurred any income or losses directly.

However, certain limited partnerships are not fiscally transparent. For example, specified investment flow-through tax (SIFT) partnerships may be taxed on some categories of Canadian income, including capital gains. A partnership may be a SIFT partnership if its investments are, or become, listed or traded on a public market.

Non-resident investors

When structuring a Canadian fund that may be offered to investors who do not reside in Canada, managers may want to consider blocking strategies to minimise Canadian tax reporting and tax leakage.

While a non-resident investor in a Canadian fund will generally not be subject to Canadian federal income tax on its share of income from a business carried on by the fund outside Canada, it may notably incur taxes as a result of capital gains resulting from the disposition of 'taxable Canadian property' (TCP) by the fund, or from the disposition of an interest in the fund, if it qualifies as TCP. The following may constitute TCP: Canadian real or resource property; assets used in carrying on a business in Canada; and interests in entities that, at any time in the five-year period preceding the disposition, directly or indirectly derived more than 50 per cent of their value from Canadian real or resource property.

In addition, a limited partnership with limited partners who are non-residents of Canada will be deemed to be a non-resident person for the purposes of Canadian withholding tax. Subject to reductions under an applicable income tax treaty, the withholding rate tax is

25 per cent of the gross amount of the payment. Accordingly, a non-resident investor in a Canadian fund will be subject to Canadian withholding tax on certain Canadian-source non-business income, including dividends and certain types of interests.

Key changes

Value added tax may be imposed in Canada. More specifically, a federal component (goods and services tax (GST)) is applied at a 5 per cent rate, while a provincial component may be applied at an 8 per cent or 10 per cent rate depending on the province (collectively with the GST, harmonised sales tax (HST)).

Generally, HST must be paid by private equity funds structured as limited partnerships investing in shares or debt, and typically this tax may not be recovered by way of input tax credits. Distributions to a partner in consideration for its activities as a partner, however, are generally not subject to HST. For this reason, in some cases, a fund's general partner as opposed to a third-party manager would carry out the management activities (since payments to such a third-party manager would generally have been subject to unrecoverable HST). To address this issue, legislation was enacted in December 2018 to impose HST on the fair market value of management services provided to certain funds by their general partner. The legislation will apply to 'investment limited partnerships' (very generally, limited partnerships whose assets consist primarily of financial instruments such as shares, debt, trust units or other partnership interests).

In addition to the above, as HST is not applied in certain provinces, GST is theoretically the only value added tax payable making it more attractive to establish funds in those provinces. To limit this advantage, certain rules that apply to most investment funds impose HST on the basis of the residence of a fund's investors. However, most funds structured as limited partnerships were not subject to these allocation rules. To address this issue, legislation was enacted in December 2018 to extend the scope of the allocation rules to funds structured as limited partnerships as of 2019.

IV OUTLOOK

As previously mentioned, one of the most interesting recent trends in private equity fundraising is the emergence of evergreen private equity funds. Unlike their closed-ended counterparts, evergreen funds do not have a set life and continue until terminated.

This trend is driven both by the desire of managers to have permanent vehicles to manage and pressure from institutional investors who espouse a longer-term investment objective and do not want to be tied to a closed-ended investment cycle. Institutional investors are also attracted by the asset diversification provided by existing evergreen funds. Rather than committing capital to a new structure, an institutional investor committing to an existing evergreen fund can expect, when its capital is called, to participate in the assets already held by that evergreen fund.

The terms of evergreen funds are a hybrid of the terms of traditional closed-ended private equity funds and open-ended funds (mutual funds, hedge funds). In evergreen funds, new and existing investors can make new commitments to the fund any time the general partner opens the fund to new commitments. The investment period is tied to an investor's specific capital commitment rather than set from the initial closing of the fund.

With all its advantages, evergreen funds face challenges that stem from the illiquid nature of their assets – the exit of investors (redemptions), the valuation of their interests

(for the purposes of subscriptions and redemptions), the structure of the carried interest and the timing of its crystallisation and payment are only a few of the challenges it must tackle and address. While we are still years away from 'market standard' terms for evergreen funds, their popularity with established managers and investors alike is undeniable and both market participants are keen to surmount those challenges.

Another emerging trend in private equity fundraising in light of low interest rates is that Canadian private equity funds are increasingly having recourse to fund-level credit facilities that are becoming more commonly used and are put in place for longer periods and larger amounts. We have seen instances of such credit facilities being used by managers to replace capitals calls at the beginning the fund's life. It will be interesting to see how fund-level credit facilities will affect current market terms.

Lastly, the secondaries market has flourished in recent years in Canada, as it has in the entire North American market and in the European market, with GP-led secondary transactions continuing to grow in popularity in 2019 with Canadian private equity funds.

Appendix 1

ABOUT THE AUTHORS

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Jonathan Halwagi provides counsel in the areas of asset management and investment funds. His practice focuses on the establishment of fund structures with an emphasis on alternative asset management (including private equity, venture capital, infrastructure and lending). He also regularly acts for Canadian and international asset managers, assisting them with their compliance with applicable Canadian securities laws and regulations.

Jonathan assists asset managers in their dealings with Canadian regulators and counsels them on acquisitions, joint ventures and mergers.

Before joining Fasken, Jonathan practised with a leading UK law firm in its investment funds group.

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Tracy Hooey is vice chair of Fasken's business law practice in Ontario. Her practice is focused on securities and mergers and acquisitions. She advises public and private clients on a range of transactional matters, including securities offerings, acquisitions and divestitures, investment product structuring and corporate governance and securities law compliance matters.

Tracy also works extensively with participants in the investment product and wealth management industries. She advises clients on fund formation matters, including the structuring of public retail funds, private equity and venture capital funds, pooled funds and structured limited partnership vehicles created for special purpose acquisitions or alternative asset classes. As a result of her securities regulatory experience, Tracy is regularly engaged in transaction work in the investment product and wealth management industries, fund governance and registrant compliance matters, including for new entrants in the fintech space that require assistance navigating the securities regulatory compliance requirements.

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Anabel Quessy's corporate law practice focuses on serving the investment management industry. As part of the investment management practice team, Anabel regularly counsels asset and fund managers in connection with compliance with applicable securities laws and regulations and assists them in setting up new investment funds, including alternative asset management structures (notably private equity, venture capital, infrastructure and lending). Anabel also accompanies clients through mergers and acquisitions of investment management businesses, helping clients at all stages of the process, from the initial deal structuring to the post-closing integration of assets.

Anabel also advises institutional investors on corporate issues and the governing regulatory framework.

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Ryan Rabinovitch is a partner in the tax group. Ryan's practice deals with all aspects of tax law, with a particular focus on tax planning and tax litigation.

Over the years, Ryan has held a variety of positions in the legal profession, from which he has gained broad expertise. He worked as a comparative law clerk for Aharon Barak, the then President of the Supreme Court of Israel, and served as law clerk to the Honourable Louise Arbour, then a justice of the Supreme Court of Canada.

Before joining Fasken, Ryan practised with an international law firm.

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